Yangarra Resources Ltd.

Consolidated Financial Statements

December 31, 2007

Management's Responsibility

To the Shareholders of Yangarra Resources Ltd.:

Management is responsible for the preparation and presentation of the accompanying financial statements, including responsibility for significant accounting judgments and estimates in accordance with Canadian generally accepted accounting principles and ensuring that all information in the annual report is consistent with the statements. This responsibility includes selecting appropriate accounting principles and methods, and making decisions affecting the measurement of transactions in which objective judgment is required.

In discharging its responsibilities for the integrity and fairness of the financial statements, management designs and maintains the necessary accounting systems and related internal controls to provide reasonable assurance that transactions are authorized, assets are safeguarded and financial records are properly maintained to provide reliable information for the preparation of financial statements.

The Board of Directors exercises its responsibilities for financial controls through an Audit Committee. The Audit Committee is responsible for overseeing management in the performance of its financial reporting responsibilities, and for approving the financial information included in the annual report. The Committee has the responsibility of meeting with management and external auditors to discuss the internal controls over the financial reporting process, auditing matters and financial reporting issues. The Committee is also responsible for recommending the appointment of the Company's external auditors.

Meyers Norris Penny LLP, an independent firm of Chartered Accountants, is appointed by the shareholders to audit the financial statements and report directly to them; their report follows. The external auditors have full and free access to, and meet periodically and separately with, both the Audit Committee and management to discuss their audit findings.

April 22, 2008

"James G. Evaskevich" (signed)
James G. Evaskevich
Chief Executive Officer

"Penny Payne" (signed)
Penny Payne
Chief Financial Officer

To the Shareholders of Yangarra Resources Ltd.:

We have audited the consolidated balance sheets of Yangarra Resources Ltd. as at December 31, 2007 and 2006, and the consolidated statements of operations, comprehensive loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2007 and 2006, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Meyers Norris Penny LLP

Calgary, Alberta
April 22, 2008

Chartered Accountants

Yangarra Resources Ltd.
Consolidated Balance Sheets
As at December 31

	2007	2006
Assets		
Current		
Accounts receivable	$ **1,285,141**	$ 1,795,688
Prepaid expenses and deposits	**227,195**	249,497
Deferred financing fees *(notes 3 and 8)*	**–**	114,750
	1,512,336	2,159,935
Investment *(note 5)*	**125,620**	109,258
Property and equipment *(note 6)*	**40,371,767**	46,012,569
	$ **42,009,723**	$ 48,281,762
Liabilities		
Current		
Bank indebtedness	$ **95,464**	$ 479,925
Bank debt *(note 7)*	**7,600,000**	10,100,000
Credit facility *(note 8)*	**4,331,007**	5,000,000
Accounts payable and accrued liabilities	**2,320,393**	4,197,732
	14,346,864	19,777,657
Long-term payable *(note 8)*	**45,000**	–
Asset retirement obligation *(note 9)*	**1,740,366**	1,508,698
Future income tax liability *(note 14)*	**1,864,734**	3,055,830
	17,996,964	24,342,185
Shareholders' Equity		
Share capital *(note 10)*	**32,533,251**	31,474,785
Warrants *(note 11)*	**61,970**	–
Contributed surplus *(note 12)*	**1,808,044**	1,571,300
Deficit	**(10,390,506)**	(9,106,508)
	24,012,759	23,939,577
	$ **42,009,723**	$ 48,281,762

Approved on behalf of the Board of Directors

"James G. Evaskevich" (signed)
James G. Evaskevich

"Gordon A. Bowerman" (signed)
Gordon A. Bowerman

The accompanying notes are an integral part of these financial statements

	2007	2006
Revenue		
Petroleum and natural gas sales	$ **7,899,964**	$ 9,439,251
Royalties	**(1,039,249)**	(1,335,695)
	6,860,715	8,103,556
Other income *(note 13)*	**244,800**	10,459
	7,105,515	8,114,015
Expenses		
Production	**992,198**	1,689,564
Transportation	**179,880**	175,681
General and administrative	**1,106,879**	1,287,103
Interest and financing fees	**1,423,942**	1,082,204
Stock-based compensation *(note 12)*	**177,942**	251,168
Depletion and depreciation	**5,743,923**	6,241,307
Accretion	**104,310**	91,118
Impairment loss on goodwill *(note 4)*	–	396,208
Gain on investment *(note 5)*	**(142,522)**	–
	9,586,552	11,214,353
Loss before income taxes	**(2,481,037)**	(3,100,338)
Income taxes		
Future income tax recovery *(note 14)*	**(1,209,924)**	(1,137,199)
Net loss and comprehensive loss for the year	**(1,271,113)**	(1,963,139)
Deficit, beginning of year	**(9,106,508)**	(7,143,369)
Changes in accounting polices *(note 3)*	**(12,885)**	–
Deficit, end of year	$ **(10,390,506)**	$ (9,106,508)
Net loss per share – basic and diluted	$ **(0.02)**	$ (0.04)
Weighted average number of shares – basic and diluted	**55,896,744**	53,759,207

The accompanying notes are an integral part of these financial statements

		2007		2006
Operating				
Net loss for the year	$	**(1,271,113)**	$	(1,963,139)
Add back (deduct) non-cash items				
Interest expense and financing fees		**157,872**		223,250
Stock-based compensation		**177,942**		251,168
Depletion and depreciation		**5,743,923**		6,241,307
Accretion		**104,310**		91,118
Impairment loss on goodwill		**–**		396,208
Gain on investment		**(142,522)**		–
Future income tax recovery		**(1,209,924)**		(1,137,199)
Abandonment expenditures *(note 9)*		**(56,263)**		–
		3,504,225		4,102,713
Change in non-cash working capital *(note 15)*		**(415,775)**		(439,980)
		3,088,450		3,662,733
Financing				
Issue of equity instruments		**1,132,000**		132,200
Equity instrument issue costs		**(16,174)**		(16,758)
Bank debt (repayment) proceeds, net		**(2,500,000)**		650,000
Credit facility (repayment) proceeds		**(500,000)**		5,000,000
Financing fees		**(180,000)**		(218,000)
Change in non-cash working capital *(note 15)*		**55,410**		–
		(2,008,764)		5,547,442
Investing				
Expenditures on property and equipment		**(3,267,994)**		(9,757,009)
Proceeds on disposition of property and equipment		**3,430,734**		207,000
Proceeds on sale of investment *(note 5)*		**126,160**		–
Change in non-cash working capital *(note 15)*		**(984,125)**		(221,762)
		(695,225)		(9,771,771)
Increase (decrease) in cash during the year		**384,461**		(561,596)
(Bank indebtedness) cash, beginning of year		**(479,925)**		81,671
Bank indebtedness, end of year	$	**(95,464)**	$	(479,925)

Supplemental cash flow information

Interest paid	$	**1,266,070**	$	**802,300**

The accompanying notes are an integral part of these financial statements

1. Nature of operations and basis of presentation

Yangarra Resources Ltd. (the "Company") was formed by the amalgamation on November 9, 2005, under the Business Corporations Act (Alberta), of Yangarra Resources Inc. and TriOil Ltd. The Company is involved in the production, exploration and development of resource properties.

These consolidated financial statements have been prepared on a going concern basis which contemplates the realization of assets and the payment of liabilities in the ordinary course of business. As at December 31, 2007, the Company had a working capital deficit of $12,834,528 (2006 – $17,617,722) and an accumulated deficit of $10,390,506 (2006 – $9,106,508). Should the Company be unable to continue as a going concern, it may be unable to realize the carrying value of its assets and to meet its liabilities as they become due. The Company's ability to continue as a going concern is dependent upon its ability to attain profitable operations and generate funds therefrom and to continue to obtain capital financing from investors sufficient to meet current and future obligations.

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Yangarra Resources Corp. ("YRC") after the elimination of intercompany transactions and balances.

2. Significant accounting policies

The consolidated financial statements have been prepared by management in accordance with generally accepted accounting principles in Canada. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts recorded in the financial statements and accompanying notes. Actual results could differ from these estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment with reasonable limits of materiality and within the framework of the significant accounting policies summarized below:

a) ***Cash and cash equivalents***

Cash and cash equivalents consist of bank balances (overdrafts) and term deposits with maturities of three months or less.

b) ***Investments***

Investments are classified as held-for-trading financial assets (note 3(a)) and are measured at fair value with changes in fair value recognized in earnings.

c) ***Property and equipment***

The Company follows the full cost method of accounting for its petroleum and natural gas operations. Under this method all costs related to the acquisition of, exploration for, and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses, stock-based compensation directly related to field personnel, costs of drilling both productive and non-productive wells and overhead costs directly related to exploration and development activities which have been charged in accordance with standard industry operating agreements. Proceeds from the sale of resource properties are applied against capitalized costs, without any gain or loss being realized, unless such sale would alter the rate of depletion by greater than 20%.

Depletion of resource properties and related equipment, net of estimated salvage or residual value, is provided using the unit of production method based upon estimated proven resource reserves before royalties, as determined by independent engineers. For depletion purposes, relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

2. Significant accounting policies (continued)

c) *Property and equipment* (continued)

Other property and equipment, such as computer and office equipment and leasehold improvements ("office equipment"), are initially recorded at cost.

Depreciation is provided using methods and rates intended to depreciate the cost of office equipment over estimated useful lives.

	Method	Rate
Computer equipment	declining balance	30 %
Leasehold improvements	straight-line	5 years
Office equipment	declining balance	20 %

d) *Long-lived assets*

Long-lived assets consist of property and equipment and resource properties. Long-lived assets held for use are measured, depleted or depreciated as described in the applicable accounting policies.

The Company performs impairment testing on long-lived assets held for use whenever events or changes in circumstances indicate that the carrying value of property and equipment or resource properties may not be recoverable. Impairment losses are recognized when undiscounted future cash flows from the Company's proved reserves, undeveloped land and future development projects are less than the carrying value of property and equipment and resource properties. Any impairment is included in earnings for the year.

If the carrying value is assessed not to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the property and equipment and resource properties exceeds the sum of the discounted cash flows from proved plus probable reserves, undeveloped land and future development projects. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

e) *Joint venture operations*

A portion of the Company's petroleum and natural gas exploration and production activities are conducted jointly with others, and, accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

f) *Bank debt*

The Company classifies borrowings as a current liability where the lender has a right to demand payment within twelve months, or where the lender may not re-finance the borrowing for a further lending period longer than twelve months.

g) *Asset retirement obligation*

Asset retirement costs and liabilities associated with site restoration and abandonment of long-lived assets are initially measured at a fair value which approximates the cost a third party would incur in performing the tasks necessary to retire such assets. Such costs are capitalized as part of the cost of property and equipment and amortized to expense through depletion over the life of the asset. The change in the liability due to the passage of time is measured by applying an interest method of allocation to the opening liability and is recognized as an increase in the carrying value of the liability and an expense. The expense is recorded as accretion expense in the statement of operations. A change in the liability resulting from revisions to either the timing or the amount of the original estimate of undiscounted cash flows is recognized as an increase or decrease in the carrying amount of the liability, with an offsetting increase or decrease in the carrying amount of the associated asset.

2. Significant accounting policies (continued)

h) *Future income taxes*

The Company follows the asset and liability method of accounting for future income taxes. Under this method, future income tax assets and liabilities are recorded based on temporary differences between the carrying amount of balance sheet items and their corresponding tax bases. In addition, the future benefits of income tax assets, including unused tax losses, are recognized, subject to a valuation allowance, to the extent that it is more likely than not that such future benefits will ultimately be realized. Future income tax assets and liabilities are measured using enacted tax rates and laws expected to apply when the tax liabilities or assets are to be either settled or realized.

i) *Flow through shares*

Expenditure deductions for income tax purposes related to exploratory activities funded by flow-through equity instruments are renounced to investors in accordance with income tax legislation. The Company provides for the future effect on income taxes related to flow-through equity instruments as a reduction of share capital and an increase in future income tax liabilities when the renouncement documents are filed with taxation authorities.

j) *Stock-based compensation*

Stock-based compensation expense is based on the estimated fair value of options granted at the time of the grant. The fair value is recognized as stock-based compensation with a corresponding increase to contributed surplus over the vesting period of the options. Upon the exercise of the stock options, consideration paid together with the amount previously recognized in contributed surplus is recorded as an increase in share capital. In the event that vested options expire, previously recognized compensation expense associated with such stock options is not reversed. In the event that unvested options are cancelled, previously recognized compensation expense associated with such stock options is reversed.

k) *Per share amounts*

Basic earnings per share is calculated using the weighted average number of shares outstanding during the year. Diluted earnings per share is calculated based on the treasury stock method which assumes that any proceeds obtained on the exercise of options and warrants would be used to purchase common shares at the average price during the period. The effect of anti-dilutive options and warrants is not included in the calculation of diluted earnings per share.

l) *Revenue recognition*

Revenue is recognized from oil sales when the oil is delivered to the buyer and from gas sales when the gas passes through the pipeline at the delivery point.

m) *Commodity contracts*

Commodity contracts that do not meet the criteria for the use of hedge accounting are recorded on the balance sheet at fair value and changes in fair value are recognized in income in the period in which the change occurs.

n) *Use of estimates*

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period.

2. Significant accounting policies (continued)

n) ***Use of estimates*** (continued)

Accounts receivable are stated after evaluation as to their collectibility and an appropriate allowance for doubtful accounts is provided where considered necessary. Amounts recorded for depletion of resource properties, amortization of property and equipment, asset retirement obligations and impairment calculations are based on estimates of natural gas and crude oil reserves and future costs required to develop those reserves. Amounts related to the fair value of stock options and warrants are based on estimates of share price volatility, risk-free interest rate and expected lives of options and warrants.

By their nature, these estimates and related future cash flows are subject to measurement uncertainty, and the impact on the consolidated financial statements of future periods could be material. These assumptions are reviewed periodically and, as adjustments become necessary, they are reported in earnings in the periods in which they become known.

3. Changes in accounting policies

On January 1, 2007, the Company adopted the new or revised Canadian accounting standards for accounting changes, comprehensive income, financial instruments—recognition and measurement and financial instruments—presentation and disclosures. Prior periods have not been restated.

a) ***Section 3855 Financial Instruments – Recognition and Measurement***

This new standard requires all financial instruments within its scope, including all derivatives, to be recognized on the balance sheet initially at fair value. Subsequent measurement of all financial assets and liabilities except those held-for-trading and available for sale are measured at amortized cost determined using the effective interest rate method. Held-for-trading financial assets are measured at fair value with changes in fair value recognized in earnings. Available-for-sale financial assets are measured at fair value with changes in fair value recognized in comprehensive income and reclassified to earnings when derecognized or impaired. Changes to the measurement of existing financial assets and liabilities at the date of adoption were adjusted to opening deficit as noted below.

The Company has classified its financial assets and liabilities as follows:

Held-for-trading	Loans and receivables	Other liabilities
Investment	Accounts receivable	Bank debt
Bank indebtedness		Credit facility
		Accounts payable and accrued liabilities

The Company may use various types of derivative financial instruments to manage risks associated with crude oil and natural gas price fluctuations. These instruments are not used for trading or speculative purposes. Proceeds and costs realized from holding the related contracts are recognized in petroleum and natural gas revenues at the time that each transaction under a contract is settled. For the unrealized portion of such contracts, the Company utilizes the fair value method of accounting. The fair value is based on an estimate of the amounts that would have been paid to or received from counterparts to settle these instruments given future market prices and other relevant factors. The method requires the fair value of the derivative financial instruments to be recorded at each balance sheet date with the unrealized gains or losses on these contracts recorded through the consolidated statement of operations.

3. Changes in accounting policies (continued)

c) ***Section 3855 Financial Instruments – Recognition and Measurement*** (continued)

The Company has elected to account for its commodity sales and other non-financial contracts, which were entered into and continue to be held for the purpose of receipt or delivery of non-financial items in accordance with its expected purchase, sale or usage requirements as executory contracts on an accrual basis rather than as non-financial derivatives. Prior to adoption of the new standards, physical receipt and delivery contracts did not fall within the scope of the definition of a financial instrument and were also accounted for as executory contracts.

Transaction costs attributable to financial instruments classified as other than held-for-trading are included in the recognized amount of the related financial instrument and recognized over the life of the resulting financial instrument. Prior to January 1, 2007, transaction costs were recorded as deferred financing fees and recognized in the statement of operations on a straight-line basis over the life of the financial instrument. On adoption, transaction costs are recognized as if the effective interest rate method had always been applied whereby the amount recognized varies over the life of the financial instrument based on the principal outstanding. For the Company, the adoption of the effective interest rate method required adjustments to deferred financing fees and the credit facility as disclosed below.

At January 1, 2007, the following adjustments were made to the balance sheet to adopt the new standards:

		January 1 2007
Deficit – increase	$	12,885
Deferred financing fees – decrease		(114,750)
Credit facility – decrease		101,865

b) ***Section 3865 Hedges***

This new standard specifies the circumstances under which hedge accounting is permissible and how hedge accounting may be performed. On adoption of these standards, the Company did not have any agreements or contracts which are following hedge accounting.

c) ***Section 1530 Comprehensive Income***

Comprehensive income (loss) is the change in shareholders' equity during a period from transactions and other events and circumstances from non-owner sources and includes unrealized gains and losses on financial assets classified as held available-for-sale. The Company has reported a consolidated statement of comprehensive loss combined with the consolidated statement of operations. When related amounts are recorded in accordance with this new standard, a new category for accumulated other comprehensive income will be presented in the shareholders' equity section of the consolidated balance sheet.

d) ***Section 1506 Accounting Changes***

Voluntary changes in accounting policies are permitted only if they result in financial statements which provide more reliable and relevant information. Accounting policy changes are applied retrospectively unless it is impracticable to determine the period or cumulative impact of the change. Corrections of prior period errors are applied retrospectively and change in accounting estimates are applied prospectively by including the effect of the change in earnings.

3. Changes in accounting policies (continued)

e) *Pending accounting pronouncements:*

The Company is currently assessing the impact of these following new standards on its consolidated financial statements:

i) *Capital Disclosures and Financial Instruments – Disclosures and Presentation*

On December 1, 2006 three new accounting standards were issued by the CICA. These were Section 1535 Capital Disclosures, Section 3862 Financial Instruments – Disclosure and Section 3863 Financial Instruments – Presentation. These new standards will be effective on January 1, 2008.

Section 1535 specifies the disclosure of (i) an entity's objectives, policies, and processes for managing capital, (ii) quantitative data about what the entity regards as capital, (iii) whether the entity has complied with any capital requirements, and (iv) if it has not complied, the consequences of such non-compliance.

The new Sections 3862 and 3863 replace Section 3861 Financial Instruments – Disclosure and Presentation, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks.

ii) *International Financial Reporting Standards ("IFRS")*

In 2005, the Accounting Standards Board of Canada ("AcSB") announced that accounting standards in Canada are to converge with IFRS. The AcSB has indicated that Canadian entities will need to begin reporting under IFRS by the first quarter of 2011 with appropriate comparative data from the prior year. Under IFRS, the primary audience is capital markets and as a result, there is significantly more disclosure required, specifically for quarterly reporting. Further, while IFRS uses a conceptual framework similar to Canadian GAAP, there are significant differences in accounting policy which must be addressed.

iii) *Inventories*

In March 2007, Section 3031 Inventories was adopted which aligns Canadian GAAP with IFRS. This standard will be effective on January 1, 2008.

iv) *Goodwill and intangible assets*

In January 2008, Section 3064 Goodwill and Intangible Assets was issued to replace Section 3062 Goodwill and Other Intangible Assets and Section 3450 Research and Development Costs. This standard aligns Canadian GAAP with IFRS and will be effective on October 1, 2008.

4. Goodwill

Goodwill was acquired through the November 9, 2005 amalgamation between Yangarra Resources Inc. and TriOil Ltd. As at December 31, 2006, the Company determined that the $396,208 carrying value of goodwill was not recoverable and consequently wrote-off the carrying value as a loss on the impairment of goodwill in the consolidated statement of operations.

5. Investment

The Company holds a minority equity position in a public company. In November 2007, the Company disposed of a portion of its investment for proceeds of $126,160, resulting in a gain of $59,490. As at December 31, 2007, the fair value of the Company's investment was $125,620. As a consequence of adopting new financial instruments standards (note 3), the $83,032 difference between the pro-rata carrying value reported at December 31, 2006 and the December 31, 2007 fair value has been recognized as a gain on investment in the consolidated statement of operations.

6. Property and equipment

	December 31, 2007		
	Cost	*Accumulated depletion and depreciation*	*Net book value*
Petroleum and natural gas properties	$ 58,852,116	$ 18,570,591	$ 40,281,525
Office equipment	241,445	151,203	90,242
	$ 59,093,561	$ 18,721,794	$ 40,371,767

	December 31, 2006		
	Cost	*Accumulated depletion and depreciation*	*Net book value*
Petroleum and natural gas properties	$ 58,748,195	$ 12,868,391	$ 45,879,804
Office equipment	242,245	109,480	132,765
	$ 58,990,440	$ 12,977,871	$ 46,012,569

At December 31, 2007, the Company excluded $1,443,634 (2006 – $1,965,988) of resource properties relating to unproved properties from the depletion calculation. Unproved properties have been separately evaluated by management for impairment. In addition, $9,320,900 (2006 – $10,279,000) of future development costs were included in the depletion calculation.

During 2007, the Company capitalized $183,621 (2006 – $179,354) related to the asset retirement obligation of property and equipment and $82,240 (2006 – $374,104) comprised of stock-based compensation of $58,802 and $23,438 of related future income taxes (2006 – $265,614 and $108,490, respectively) for options granted to field consultants. The Company did not capitalize any general and administrative costs during 2007 or 2006 other than to the extent of the Company's working interest in operated capital expenditure programs on which operator's fees have been charged in accordance with standard industry operating agreements.

In July 2007, the Company sold certain assets for proceeds of $2,853,734, net of closing adjustments. In December 2007, the Company sold equipment for proceeds of $577,000.

The Company applied the ceiling test to its capitalized assets as at December 31, 2007 and determined that there was no impairment. For purposes of this impairment test, the following future commodity prices were used:

	WTI US$/bbl	*WTI Cdn $/bbl*	*Alberta AECO-C Spot Cdn $/mcf*
2008	85.00	83.30	6.90
2009	81.60	77.52	7.75
2010	81.15	74.66	8.10
2011	79.60	71.64	8.50
2012	77.95	70.16	8.65
Escalation rate thereafter	2%	2%	2%

7. Bank debt

As at December 31, 2007, the Company's revolving operating demand loan was available to a maximum of $8,400,000 (2006 – maximum of $11,500,000), of which the Company had drawn $7,600,000 (2006 – $10,100,000). In February 2008, the available maximum was increased to $8,500,000. Pursuant to the terms of the bank debt, the Company is subject to a financial covenant with respect to working capital, which the Company was in compliance with at December 31, 2007.

The revolving operating demand loan requires payments of interest only and is subject to the lender's review and right of demand. Interest is calculated daily and payable monthly at prime plus 0.5% (2006 – prime plus 0.5%). In addition to the revolving operating demand loan facility, the Company has a treasury risk line available for interest rate, foreign exchange and commodity risk management which is repayable per contract maturities. The Company has not drawn any amounts under the treasury risk line.

The credit facilities are secured by a general assignment of book debts, a $10,000,000 debenture, a $35,000,000 supplemental debenture, evidence of insurance coverage with the lender as first loss payee, title representation of petroleum and natural gas reserves, and assignment of revenues and monies under material contracts. The debentures contain a floating charge over all assets of the Company with a negative pledge and undertaking to provide fixed charges on the Company's major producing petroleum and natural gas reserves.

8. Credit facility

As at December 31, 2007, the Company had a $4,500,000 credit facility (2006 – $5,000,000) bearing interest at 9% (2006 – 9%) per annum calculated and payable monthly and maturing on December 31, 2008. Pursuant to the renewal of the credit facility in December 2007, the interest rate was revised to 12%. In addition, the Company is required to pay a 4% deferred fee upon partial or full repayment of outstanding balances under the credit facility. Pursuant to the terms of the credit facility, the Company is subject to financial covenants for working capital, debt to equity and debt to trailing cash flow commencing on March 31, 2008.

In conjunction with the 2007 credit facility and renewal, the Company paid fees of $225,000 including $45,000 recorded as a long-term payable settled through the issuance of 450,000 common shares upon receipt of regulatory approval in January 2008. Financing fees have been netted against the principal amount of the 2007 credit facility and are being amortized to interest in the consolidated statement of operations using the effective interest rate method. As at December 31, 2007, the amortized cost of the credit facility was $4,331,007.

In conjunction with the 2006 credit facility, the Company paid fees of $266,441 which were recorded to deferred financing fees. Of this amount, $120,000 was paid by the issuance of 292,683 common shares of the Company. Deferred financing fees were amortized over the term of the facility to financing fees on the consolidated statement of operations and deficit. At December 31, 2006, amortization of $151,691 had been recorded to financing fees, resulting in the $114,750 reported carrying value of deferred financing fees. As a consequence of adopting the new financial instruments standards, the Company made certain adjustments to previously deferred financing fees and the 2006 credit facility as disclosed in note 3(a).

The credit facility is secured by a $7,500,000 demand debenture providing a second priority security interest over all personal property assets of the Company, a second priority floating charge security interest over all real property assets of the Company and a negative pledge and undertaking to provide fixed charges on the Company's petroleum and natural gas reserves as selected by the lender, evidence of insurance coverage with the lender as second loss payee, title representation of petroleum and natural gas reserves, a corporate guarantee from YRC secured by a $7,500,000 demand debenture and a negative pledge and undertaking and an Interlender, Subordination, Postponement and Priority Agreement between the lender and the senior lender (note 7).

9. Asset retirement obligation

The following table presents the reconciliation of the carrying amount of the obligation associated with the retirement of the Company's property and equipment:

	2007	*2006*
Asset retirement obligation, beginning of year	$ 1,508,698	$ 1,238,226
Liabilities incurred	47,835	163,242
Dispositions	(48,865)	–
Liabilities settled	(56,263)	–
Effect of change in estimates	184,651	16,112
Accretion	104,310	91,118
Asset retirement obligation, end of year	$ 1,740,366	$ 1,508,698

The following significant assumptions were used to estimate the asset retirement obligation:

	2007	*2006*
Undiscounted cash flows	$ 3,965,076	$ 2,842,306
Discount rate	7%	7%
Inflation rate	2%	2%
Weighted average expected timing of cash flows	12.8 years	9.8 years

10. Share capital

a) Authorized

Unlimited number of common shares, without nominal or par value
Unlimited number of first preferred shares, without nominal or par value
Unlimited number of second preferred shares, without nominal or par value

b) Common shares issued

	Number of shares	*Amount*
Balance, December 31, 2005	53,431,491	$ 31,188,344
Exercise of options *(i)*	265,500	177,617
Financing fees *(ii)*	292,683	120,000
Share issue costs, net of tax of $5,582	–	(11,176)
Balance, December 31, 2006	53,989,674	$ 31,474,785
Private placement *(iii)*	9,406,493	1,070,030
Share issue costs, net of tax of $4,610	–	(11,564)
Balance, December 31, 2007	63,396,167	$ 32,533,251

i) During January and February 2006, 265,500 shares were issued on the exercise of the same number of options for total cash proceeds of $132,200 plus a pro-rata share of the related fair value previously recorded to contributed surplus in the amount of $45,417.

10. Share capital (continued)

b) Common shares issued (continued)

ii) In September 2006, the Company issued 292,683 shares as consideration for $120,000 of financing fees related to the 2006 credit facility (note 8).

iii) In October 2007, the Company completed two non-brokered unit private placements for total gross proceeds of $1,132,000, of which $933,000 was subscribed for by officers and directors of the Company. At the time of the private placements, the fair value of the warrants was estimated to be $61,970 and the remaining $1,070,030 was ascribed to common shares. The units are described as follows:

i. 6,163,636 common share units at $0.11 per unit for gross proceeds of $678,000. Each unit is comprised of one common share of the Company and one-half of a share purchase warrant. Each whole share purchase warrant entitles the holder to acquire one common share at $0.17 per share at anytime prior to June 30, 2008.

ii. 3,242,857 flow-through units at $0.14 per unit for gross proceeds of $454,000. Each flow-through unit is comprised of one common share issued on a flow-through basis and one-half of a share purchase warrant. Each whole share purchase warrant entitles the holder to acquire one common share at $0.17 per share at anytime prior to June 30, 2008.

The Black-Scholes pricing model used to estimate the fair value of the warrants was based on 87% expected volatility, 4.22% risk-free interest rate and 0.7 year expected life.

The related tax benefits of the flow-through share proceeds will be renounced to investors in February 2008 with an effective date of December 31, 2007. The Company has until December 31, 2008 to incur the $454,000 of qualifying flow-through expenditures of which approximately $9,410 had been incurred as at December 31, 2007.

c) Stock options

The Company has a stock option plan under which the Board of Directors may grant options to directors, officers, other employees and key consultants. The purpose of the plan is to advance the interests of the Company by encouraging these individuals to acquire shares in the Company and thereby remain associated with, and seek to maximize the value of, the Company.

Under the plan, the number of shares reserved for issuance pursuant to the exercise of all options under the plan may not exceed 10% of the issued and outstanding common shares on a non-diluted basis at any time. The options expire not more than five years from the date of grant, or earlier if the individual ceases to be associated with the Company, and vest over terms determined at the time of grant.

In 2006, the Company granted a total of 980,000 options with a weighted average exercise price of $0.38 per share and an expiry of five years from the date of grant. Of the options granted, 905,000 options vest equally over two years and 75,000 options vest equally over five years.

In June 2007, the Company granted 1,580,000 options exercisable at $0.20 per share. The options vest equally over two years and expire five years from the date of grant.

10. Share capital (continued)

c) Stock options (continued)

The Black-Scholes pricing model was used to estimate the fair value of options granted as disclosed below and based on the following significant assumptions:

	2007	*2006*
Total estimated fair value	$ 270,070	$ 340,010
Weighted average fair value per option	$0.17	$0.35
Risk-free interest rate	4.6%	3.9% to 4.1%
Expected volatility	173%	143% to 159%
Expected life	5 years	5 years

Changes in the subjective input assumptions can materially affect the fair value estimate, and therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company's stock options.

The following tables summarize information about stock options outstanding as at:

	December 31, 2007		*December 31, 2006*	
	Options	*Weighted – average exercise price*	*Options*	*Weighted – average exercise price*
Opening	4,572,950	$ 0.52	5,250,100	$ 0.62
Granted	1,580,000	0.20	980,000	0.38
Exercised	–	–	(265,500)	(0.50)
Cancelled	(2,015,675)	(0.47)	(1,391,650)	(0.81)
Closing	4,137,275	$ 0.42	4,572,950	$ 0.52

December 31, 2007

Range of exercise price	*Number outstanding*	*Weighted-average remaining contractual life (years)*	*Weighted-average exercise price*	*Number exercisable*
$ 0.20 – $ 0.45	2,096,750	4.00	$ 0.25	469,250
$ 0.46 – $ 0.55	1,230,525	2.58	0.51	1,230,525
$ 0.65 – $ 0.74	577,250	2.35	0.72	479,750
$ 0.79 – $ 0.82	232,750	1.07	0.80	232,750
	4,137,275	3.18	$ 0.42	2,412,275

11. Warrants

The following table summarizes information about warrants outstanding as at:

	December 31, 2007			*December 31, 2006*		
	Number of warrants	*Exercise price*	*Fair value ascribed*	*Number of warrants*	*Exercise price*	*Fair value ascribed*
Opening	–	$ –	$ –	1,191,662	$ 0.90	$ –
Issued	4,703,247	0.17	61,970	–	–	–
Expired	–	–	–	(1,191,662)	0.90	–
Closing	4,703,247	$ 0.17	$ 61,970	–	$ –	$ –

12. Contributed surplus

	2007	*2006*
Balance, beginning of year	$ 1,571,300	$ 1,099,935
Stock-based compensation related to:		
Options granted in current year	76,847	48,614
Options granted in prior years	228,474	272,416
Options acquired on amalgamation	–	196,335
Unvested cancelled options *(note 10(c))*	(68,577)	(583)
	236,744	516,782
Exercised options *(note 10(b)(i))*	–	(45,417)
Balance, end of year	$ 1,808,044	$ 1,571,300

Of the total $236,744 stock-based compensation recognized in 2007 (2006 – $516,782), $58,802 (2006 – $265,614) attributed to stock options granted to field personnel has been capitalized to property and equipment and the balance of $177,942 (2006 – $251,168) recorded as expense in the consolidated statement of operations.

13. Commodity contracts

a) During 2006, the Company engaged in the following put contracts for the sale of natural gas:

i) 1,000 GJ per day from October 1 to November 30, 2006 at a strike price of $6.50 per GJ and a premium cost of $0.61 per GJ; and

ii) 1,000 GJ per day from October 1 to November 30, 2006 at a strike price of $6.50 per GJ and a premium cost of $0.55 per GJ.

As at December 31, 2006, the Company had fulfilled the terms of the put contracts.

b) During 2007, the Company engaged in the following commodity collars for the sale of natural gas:

i) 1,000 GJ per day from March 1 to December 31, 2007 at a ceiling price of $10.00 per GJ and a floor price of $7.00 per GJ with a floor premium cost of $0.12 per GJ; and

ii) 1,000 GJ per day from March 1 to December 31, 2007 at a ceiling price of $8.45 per GJ and a floor price of $7.25 per GJ with a floor premium cost of $0.10 per GJ.

In July 2007, the Company settled the contract described in (ii) and received proceeds of $244,800 based on the value of the contract remaining at that date. As at December 31, 2007, the Company had fulfilled the terms of the contract described in (i).

14. Income taxes

The provision for future income taxes differs from the amount computed by applying the combined federal and provincial tax rates to the loss before taxes. The difference results from the following:

	2007	*2006*
Expected income tax recovery at 32.12% (2006 – 34.50%)	$ (796,909)	$ (1,069,617)
Non-deductible charges, including crown royalties in 2006	4,263	147,527
Stock-based compensation	57,155	86,653
Attributed Canadian Royalty Income	(20,342)	(26,974)
Utilization of non-capital losses	(45,664)	–
Rate adjustments	(292,074)	(420,818)
Other	(116,353)	162,577
Loss on impairment of goodwill	–	136,692
Resource allowance	–	(91,373)
Alberta Royalty Tax Credit	–	(61,866)
	$ (1,209,924)	$ (1,137,199)

The components of future income taxes at December 31 are:

	2007	*2006*
Future income tax assets		
Asset retirement obligation	$ 435,092	$ 437,522
Non-capital loss carryforwards	301,509	296,604
Share issue costs	72,227	179,436
Amalgamation costs	82,924	90,272
Attributed Canadian Royalty Income	–	85,753
Future income tax liabilities		
Carrying amount of property and equipment in excess of tax basis	(2,756,486)	(4,145,417)
	$ (1,864,734)	$ (3,055,830)

As at December 31, 2007, the Company has approximately $30 million of tax pools available for deduction against future taxable income. The Company also has non-capital tax losses of $833,000 available for deduction against future taxable income that expire in 2009 and 2010.

15. Change in non-cash working capital

	2007	*2006*
Accounts receivable	$ 510,547	$ 871,823
Prepaid expenses and deposits	22,302	(106,207)
Accounts payable and accrued liabilities	(1,877,339)	(1,427,358)
	$ (1,344,490)	$ (661,742)

15. Change in non-cash working capital (continued)

The change in non-cash working capital has been allocated to the following activities:

		2007		*2006*
Operating	$	(415,775)	$	(439,980)
Financing		55,410		–
Investing		(984,125)		(221,762)
	$	(1,344,490)	$	(661,742)

16. Commitments

a) The Company has entered into lease agreements for office premises and equipment with estimated minimum annual payments as follows:

2008	$ 234,508
2009	160,800
2010	31,123

b) In February 2008, the Company committed to the following commodity collars for the sale of natural gas:

i) 500 GJ per day from April 1 to December 31, 2008 at a ceiling price of $8.46 per GJ and a floor price of $7.25 per GJ;

ii) 500 GJ per day from April 1 to December 31, 2008 at a ceiling price of $8.31 per GJ and a floor price of $7.75 per GJ;

iii) 500 GJ per day from April 1 to December 31, 2008 at a ceiling price of $8.25 per GJ and a floor price of $7.00 per GJ; and

iv) 500 GJ per day from April 1 to December 31, 2008 at a ceiling price of $8.15 per GJ and a floor price of $7.50 per GJ.

17. Related party transactions

Except as disclosed elsewhere in these financial statements, the Company had the following related party transactions:

a) During the years ended December 31, 2007 and 2006, the Company was charged or invoiced the following amounts by certain of its officers and directors and by companies controlled by certain of the Company's officers and directors:

		2007		*2006*
Administration and consulting fees	$	123,498	$	164,330
Production and capital expenditures	$	148,326	$	324,649

b) During the year ended December 31, 2007, the Company was charged $29,960 (2006 – $32,299) by a law firm in which a director of the Company is a partner.

Included in accounts payable and accrued liabilities at December 31, 2007 is $93,782 (2006 – $88,037) relating to the above transactions. These transactions were in the normal course of operations and were measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

18. Contingency

The Company has filed a Statement of Claim against the operator of certain jointly held properties for which the operator has filed a defense and counterclaim. The lawsuit is subject to a Standstill Agreement while the parties attempt to negotiate a resolution. As the likely outcome of this litigation cannot be determined while the Standstill Agreement is in effect, no provision has been made in these consolidated financial statements.

19. Financial instruments

The Company, as part of its operations, carries a number of financial instruments. It is management's opinion that the Company is not exposed to significant credit, interest or currency risks arising from these financial instruments except as otherwise disclosed.

a) ***Fair value***

The carrying amount of accounts receivable, bank indebtedness, bank debt, credit facility and accounts payable and accrued liabilities approximates their fair value due to the short-term maturities of these items. Investments are reported at fair value.

b) ***Credit risk***

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of trade accounts receivable. The majority of the Company's accounts receivable are in respect of oil and natural gas operations with joint venture partners and are therefore subject to normal industry risks. Company sales are concentrated in the oil and gas industry. Approximately 37% (2006 – nil) of accounts receivable are due from one customer.

c) ***Interest rate risk***

Interest rate risk is the risk that the value of a financial instrument might be adversely affected by a change in the interest rates. In seeking to minimize the risks from interest rate fluctuations, the Company manages exposure through its normal operating and financing activities. The Company is exposed to interest rate risk primarily through its variable interest rate bank loans.

d) ***Commodity price risk***

The Company's operations are exposed to commodity price fluctuations. The Company was not a party to any hedging arrangements as at December 31, 2007 or 2006 (see notes 13 and 16).

20. Subsequent events

a) In January 2008, the Company granted 1,750,000 options exercisable at $0.10 per option, vesting immediately and expiring in January 2013.

b) In January 2008, the Company issued 450,000 common shares as settlement of a long-term payable in respect of the credit facility as disclosed in note 8.

c) In February 2008, the Company entered into four natural gas commodity collars as disclosed in note 16.

d) In April 2008, the Company issued 750,000 common shares on the exercise of the same number of warrants for cash proceeds of $127,500.