Yangarra Resources Ltd.

Consolidated Financial Statements

December 31, 2008 and 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 23, 2009

"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, 2008 and 2007, 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, 2008 and 2007, 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 13, 2009

Chartered Accountants

Yangarra Resources Ltd.
Consolidated Balance Sheets
As at December 31

		2008		2007
Assets				
Current				
Accounts receivable	$	**1,710,780**	$	1,285,141
Prepaid expenses and deposits		**437,923**		227,195
		2,148,703		1,512,336
Investment *(note 4)*		**10,468**		125,620
Property and equipment *(note 5)*		**41,922,138**		40,371,767
	$	**44,081,309**	$	42,009,723
Liabilities				
Current				
Bank debt *(note 6)*	$	**8,853,990**	$	7,695,464
Credit facility *(note 7)*		**4,665,000**		4,331,007
Accounts payable and accrued liabilities		**2,228,920**		2,320,393
		15,747,910		14,346,864
Long-term payable *(note 9)*		**–**		45,000
Asset retirement obligation *(note 8)*		**2,124,242**		1,740,366
Future income tax liability *(note 12)*		**1,757,145**		1,864,734
		19,629,297		17,996,964
Shareholders' Equity				
Share capital *(note 9)*		**34,116,201**		32,533,251
Warrants *(note 10)*		**–**		61,970
Contributed surplus *(note 11)*		**2,551,397**		1,808,044
Deficit		**(12,215,586)**		(10,390,506)
		24,452,012		24,012,759
	$	**44,081,309**	$	42,009,723

Nature of operations and basis of presentation *(note 1)*
Commitments *(note 17)*

Approved on behalf of the Board of Directors

"James G. Evaskevich" (signed)	*"Gordon A. Bowerman" (signed)*
James G. Evaskevich	**Gordon A. Bowerman**

The accompanying notes are an integral part of these financial statements

		2008		2007
Revenue				
Petroleum and natural gas sales	$	**8,642,336**	$	7,899,964
Royalties		**(1,329,490)**		(1,039,249)
		7,312,846		6,860,715
Other income *(note 15(c)(iii))*		**226,800**		244,800
		7,539,646		7,105,515
Expenses				
Production		**1,635,946**		992,198
Transportation		**193,159**		179,880
General and administrative		**813,314**		1,106,879
Interest and financing fees		**1,404,947**		1,423,942
Stock-based compensation *(note 11)*		**579,609**		177,942
Depletion and depreciation		**4,797,322**		5,743,923
Accretion		**125,069**		104,310
Loss (gain) on investment *(note 4)*		**115,152**		(142,522)
		9,664,518		9,586,552
Loss before income taxes		**(2,124,872)**		(2,481,037)
Income taxes				
Future income tax recovery *(note 12)*		**299,792**		1,209,924
Net loss and comprehensive loss for the year		**(1,825,080)**		(1,271,113)
Deficit, beginning of year		**(10,390,506)**		(9,119,393)
Deficit, end of year	$	**(12,215,586)**	$	(10,390,506)
Net loss per share – basic and diluted	$	**(0.03)**	$	(0.02)
Weighted average number of shares – basic and diluted		**67,499,983**		55,896,744

The accompanying notes are an integral part of these financial statements

	2008	2007
Operating		
Net loss for the year	$ **(1,825,080)**	$ (1,271,113)
Add back (deduct) non-cash items		
Interest and financing fees	**393,993**	157,872
Stock-based compensation	**579,609**	177,942
Depletion and depreciation	**4,797,322**	5,743,923
Accretion	**125,069**	104,310
Loss (gain) on investment	**115,152**	(142,522)
Future income tax recovery	**(299,792)**	(1,209,924)
Abandonment expenditures *(note 8)*	**(65,995)**	(56,263)
	3,820,278	3,504,225
Change in non-cash working capital *(note 13)*	**(428,503)**	(415,775)
	3,391,775	3,088,450
Financing		
Issue of equity instruments	**1,317,752**	1,132,000
Equity instrument issue costs	**(16,288)**	(16,174)
Repurchase of common shares	**(50,633)**	–
Bank debt (repayment) proceeds, net	**1,158,526**	(2,884,461)
Credit facility repayment	–	(500,000)
Financing fees	**(60,000)**	(180,000)
Related party advance *(note 9(b)(iv))*	**250,000**	–
Change in non-cash working capital *(note 13)*	–	55,410
	2,599,357	(2,393,225)
Investing		
Expenditures on property and equipment	**(5,770,571)**	(3,267,994)
Proceeds on disposition of property and equipment	**78,776**	3,430,734
Proceeds on sale of investment *(note 4)*	–	126,160
Change in non-cash working capital *(note 13)*	**(299,337)**	(984,125)
	(5,991,132)	(695,225)
Change in cash and cash equivalents during the year	–	–
Cash and cash equivalents, beginning of year	–	–
Cash and cash equivalents, end of year	$ –	$ –

	2008	2007
Supplemental cash flow information		
Interest paid	$ **1,000,543**	$ 1,266,070

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 in Western Canada.

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, 2008, the Company had a working capital deficiency of $13,599,207 (2007 – $12,834,528) and an accumulated deficit of $12,215,586 (2007 – $10,390,506). 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 within the reasonable limits of materiality and 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 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, asset retirement costs, 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. The costs of significant unevaluated properties are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties or impairment occurs.

2. Significant accounting policies (continued)

c) *Property and equipment* (continued)

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.

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, including 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. Under the full cost method of accounting, a "ceiling test" is performed to recognize and measure impairment, if any, of the carrying amount of petroleum and natural gas properties. Impairment is recognized if the carrying amount of the petroleum and natural gas properties, less the cost of undeveloped properties, net of impairment, exceeds the estimated undiscounted future cash flows from the Company's proved reserves. The future cash flows are based on a forecast of prices and costs, as provided by an independent third party. The magnitude of the impairment, if any, is then measured by comparing the carrying amount of petroleum and natural gas properties less the cost of undeveloped properties, net of impairment, to the estimated discounted future cash flows from the Company's proved and probable reserves. The future cash flows are discounted at the Company's risk-free interest rate, using forecasted prices and costs.

Any impairment recognized is recorded as additional depletion and depreciation expense.

e) *Asset retirement obligation*

Asset retirement costs and liabilities associated with site restoration and abandonment of property and equipment 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.

f) *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.

2. Significant accounting policies (continued)

g) *Bank debt and credit facility*

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.

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 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 forfeited, 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) *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. Future income tax assets and liabilities are reported based on estimates of future income tax rates. Amounts reported for the fair value of commodity price risk contracts are based on the counterparties' estimates of future commodity prices.

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.

n) ***Financial instruments***

All financial instruments, including derivatives, are 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.

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

At each balance sheet date, the Company will assess financial assets for impairment with any impairment recorded in the consolidated statement of operations.

o) ***Commodity price risk contracts***

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 counterparties 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.

The Company has elected to account for its physical delivery sales 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.

2. Significant accounting policies (continued)

p) *Transaction costs*

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 using the effective interest rate method.

q) *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.

3. Changes in accounting policies

During 2008, the Company adopted the following new or revised Canadian accounting standards. Prior periods have not been restated. The adoption of these policies had no impact on the Company's financial position or results of operations however the policies did result in new disclosures.

a) *Capital disclosures*

Section 1535 *Capital Disclosures* 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.

b) *Financial instruments*

Section 3862 *Financial Instruments – Disclosure* and Section 3863 *Financial Instruments – Presentation* replace Section 3861 *Financial Instruments – Disclosure and Presentation*. The new standards revise and enhance disclosure requirements and place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. Presentation requirements remain unchanged.

c) *Pending accounting pronouncements*

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

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

The Canadian Accounting Standards Board (AcSB) published a new strategic plan that outlines the convergence of Canadian generally accepted accounting principles with IFRS over an expected five year transitional period. The changeover date for publicly-listed companies to use IFRS, replacing Canada's own generally accepted accounting principles, is interim and annual financial statements for fiscal years beginning on or after January 1, 2011 with the restatement for comparative purposes of amounts reported by the Company for the year ended December 31, 2010. While the Company has begun assessing the adoption of IFRS for 2011, the financial reporting impact of the transition to IFRS cannot be reasonably estimated at this time.

3. Changes in accounting policies (continued)

c) *Pending accounting pronouncements* (continued)

ii) *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*. In addition, *Section 1000 Financial Statement Concepts* and *Accounting Guideline AcG 11 Enterprises in the Development Stage* were amended. The new and amended Sections clarify that costs may only be deferred when they relate to an item that meets the definition of an asset. The practice of matching revenues and expenses remains appropriate only for allocating the cost of an asset that is consumed in generating revenue over multiple reporting periods. Section 3064 provides extensive guidance on when expenditures qualify for recognition as intangible assets and aligns Canadian GAAP with IFRS. These standards are effective on January 1, 2009.

iii) *Business combinations and non-controlling interests*

In January 2009, the AcSB issued Section 1582 Business Combinations, Section 1601 Consolidations and Section 1602 Non-controlling Interests. Section 1582 replaces Section 1581 Business Combinations and provides the Canadian equivalent to IFRS 3 Business Combinations. Section 1601 and Section 1602 replace Section 1600 Consolidated Financial Statements. Section 1602 provides the Canadian equivalent to International Accounting Standard ("IAS") 27 Consolidated and Separate Financial Statements, for non-controlling interests. These standards are effective January 1, 2011.

4. Investment

The Company holds a minority equity position in a public company. As at December 31, 2008, the fair value of the Company's investment was $10,468 (2007 – $125,620). The change in fair value at each balance sheet date has been reported as an unrealized loss on investment in the consolidated statement of operations. In 2007, the Company reported a gain of $142,522 comprised of an unrealized amount of $83,032 related the change in fair value plus $59,490 realized on the disposition of a portion of its investment for proceeds of $126,160.

5. Property and equipment

December 31, 2008	*Cost*	*Accumulated depletion and depreciation*	*Net book value*
Petroleum and natural gas properties	$ 65,161,973	$ 23,337,991	$ 41,823,982
Office equipment	279,281	181,125	98,156
	$ 65,441,254	$ 23,519,116	$ 41,922,138

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

5. Property and equipment (continued)

At December 31, 2008, the Company excluded $1,773,042 (2007 – $1,443,634) of resource properties relating to unproved properties from the depletion calculation. Unproved properties have been separately evaluated by management for impairment. In addition, $7,886,400 (2007 – $9,320,900) of future development costs were included in the depletion calculation.

During 2008, the Company capitalized $324,802 (2007 – $183,621) related to the asset retirement obligation of property and equipment and $331,096 (2007 – $82,240) comprised of stock-based compensation of $248,321 and $82,775 of related future income taxes (2007 – $58,802 and $23,438, respectively) for options granted to field consultants. The Company also capitalized $107,385 (2007 – nil) of general and administrative costs as well as related costs 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.

During 2008, the Company sold certain assets for proceeds of $78,776 (2007 – $3,430,734).

The Company applied the ceiling test to its capitalized assets as at December 31, 2008 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 Average Cdn $/mcf*
2009	55.00	45.10	7.00
2010	76.50	65.79	7.90
2011	88.45	79.61	7.90
2012	100.80	95.76	8.50
2013	108.25	102.84	9.00
Escalation rate thereafter	2%	2%	2%

6. Bank debt

As at December 31, 2008, the $8,853,990 (2007 – $7,695,464) reported amount of bank debt was comprised of $8,150,000 (2007 – $7,600,000) drawn on the revolving operating demand loan and $703,990 (2007 – $95,464) of bank overdraft.

As at December 31, 2008, the Company's revolving operating demand loan was available to a maximum of $9,000,000 (2007 – $8,400,000). 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% (2007 – 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 bank 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.

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, 2008.

7. Credit facility

	2008	2007
Principal amount of credit facility	$ 4,500,000	$ 4,500,000
Unamortized portion of transaction costs	(105,000)	(168,993)
	4,395,000	4,331,007
Commitment fee for 2009 facility	90,000	–
4% deferred fee due on maturity of 2008 facility	180,000	–
	$ 4,665,000	$ 4,331,007

As at December 31, 2008, the Company had a $4,500,000 credit facility (the “2008 facility”) (2007 – $4,500,000) bearing interest at 12% (2007 – 9%) per annum calculated and payable monthly and maturing on December 31, 2008. The Company is required to pay a 4% deferred fee in the amount of $180,000 upon the maturity of the 2008 facility, payable in installments of $60,000 per month from January to March 2009.

In December 2008, the Company renewed the credit facility for a one year term commencing on January 1, 2009 and maturing on December 31, 2009 (the “2009 facility”). In respect of the 2009 facility, the Company is required to pay $105,000 of renewal and commitment fees, of which $15,000 was paid in 2008 with the remainder payable in installments of $30,000 per month from January to March 2009. These costs are net against the principal amount of the credit facility and will be amortized to interest over the term of the 2009 facility.

In 2007, the Company paid $225,000 of transaction costs 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. The 2007 transaction costs were netted against the principal amount of the credit facility and amortized to interest in the consolidated statement of operations using the effective interest rate method.

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. As at December 31, 2008, the Company was in compliance with working capital and debt to equity covenants and received an acknowledgement from the lender with respect to the breach of the debt to trailing cash flow covenant.

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 6).

8. 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:

	2008	2007
Asset retirement obligation, beginning of year	$ 1,740,366	$ 1,508,698
Liabilities incurred	115,502	47,835
Dispositions	(12,847)	(48,865)
Liabilities settled	(65,995)	(56,263)
Effect of change in estimates	222,147	184,651
Accretion	125,069	104,310
Asset retirement obligation, end of year	$ 2,124,242	$ 1,740,366

8. Asset retirement obligation (continued)

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

	2008	*2007*
Undiscounted cash flows	$ 4,450,264	$ 3,965,080
Discount rate	7% - 12%	7%
Inflation rate	2%	2%
Weighted average expected timing of cash flows	11.5 years	12.8 years

9. 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, 2006	53,989,674	$ 31,474,785
Private placement *(i)*	9,406,493	1,070,030
Share issue costs, net $4,610 of future income tax	–	(11,564)
Balance, December 31, 2007	63,396,167	$ 32,533,251
Financing fees *(ii)*	450,000	45,000
Exercise of stock options *(iii)*	1,312,500	346,742
Exercise of warrants *(iv)*	4,703,245	861,522
Private placement *(v)*	6,000,000	600,000
Purchased shares *(vi)*	(300,000)	(144,598)
Share issue costs, net of $4,072 of future income tax	–	(12,216)
Tax effect of flow-through shares *(i)*	–	(113,500)
Balance, December 31, 2008	75,561,912	$ 34,116,201

i) 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.

9. Share capital (continued)

b) Common shares issued (continued)

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 $113,500 future tax effect of the $454,000 flow-through share proceeds was recorded in February 2008 when the related tax benefits were filed with the tax authorities and renounced to investors with an effective date of December 31, 2007. As at December 31, 2008, the Company had incurred all of the qualifying flow-through expenditures.

ii) In January 2008, the Company issued 450,000 common shares as consideration for $45,000 of financing fees related to the 2007 renewal of the credit facility (note 7) which were reported as a long-term payable at December 31, 2007.

iii) In April and July 2008, the Company issued a total of 1,312,500 common shares on the exercise of the same number of stock options for cash proceeds of $168,200. In addition to the cash proceeds, a $178,542 pro-rata allocation of the options' fair value was reclassified from contributed surplus to the amount for common shares.

iv) During the second quarter of 2008, the Company issued 4,703,245 common shares on the exercise of the same number of warrants for proceeds of $799,552, of which $549,552 was paid in cash upon exercise and $250,000 was received in March 2008 as advances from two shareholders, who are also officers and directors of the Company, and applied against proceeds due at the time the shareholders exercised warrants. In addition to the proceeds, $61,970 was reclassified to the amount for common shares from the previously reported value of warrants (note 10).

v) In December 2008, the Company issued 6,000,000 common shares on a flow-through basis at $0.10 per share for total proceeds of $600,000 of which $350,000 was subscribed for by officers and directors of the Company.

The related tax benefits of the flow-through share proceeds were renounced to investors in February 2009 with an effective date of December 31, 2008. The Company has until December 31, 2009 to incur the qualifying flow-through expenditures, all of which remained unspent at December 31, 2008.

vi) In July 2008, the Company obtained regulatory approval to proceed with a normal course issuer bid (the "Bid") pursuant to which the Company may purchase up to 3,381,354 of its common shares (approximately 5% of the Company's outstanding shares) over the period of one year. All acquisitions of the Company's shares pursuant to the Bid will be made through the facilities of the TSX Venture Exchange Inc. at the market price on the date of purchase. Common shares purchased under the Bid are cancelled and returned to treasury on a monthly basis.

During August to December 2008, pursuant to the Bid, the Company purchased 300,000 of its common shares at a weighted average market price of $0.17 per share for a total cost of $50,633. At the time of purchase, the average per share reported amount of the Company's shares was $0.48 per share resulting in reduction of share capital of $144,598 for the assigned value of the purchased shares. The $93,965 difference between the assigned value and the cost of the purchased shares was credited to contributed surplus.

9. Share capital (continued)

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 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.

During 2008, the Company granted the following options which vest immediately and expire five years from the date of grant:

Granted	*Number of options*	*Exercise price*	*Estimated fair value*
January 2008	1,750,000	$ 0.10	$ 186,690
April 2008	1,875,000	0.18	366,350
June 2008	125,000	0.34	42,570
	3,750,000		$ 595,610

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

	2008	*2007*
Weighted average fair value per option	$ 0.16	$0.17
Risk-free interest rate	3.0% - 3.8%	4.6%
Expected volatility	189% - 203%	173%
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, 2008		*December 31, 2007*	
	Options	*Weighted – average exercise price*	*Options*	*Weighted – average exercise price*
Opening	4,137,275	$ 0.42	4,572,950	$ 0.52
Granted	3,750,000	0.15	1,580,000	0.20
Exercised	(1,312,500)	0.13	–	–
Expired	(232,750)	(0.70)	–	–
Forfeited	(75,000)	(0.70)	(2,015,675)	(0.47)
Closing	6,267,025	$ 0.31	4,137,275	$ 0.42

9. Share capital (continued)

c) Stock options (continued)

Range of exercise price	*Number outstanding*	*Weighted-average remaining contractual life (years)*	*Weighted-average exercise price*	*Number exercisable*
$ 0.10 – $ 0.35	4,444,000	3.86	$ 0.19	4,444,000
$ 0.45 – $ 0.55	1,259,025	1.58	0.51	1,259,025
$ 0.65 – $ 0.74	502,250	1.24	0.72	502,250
$ 0.82	61,750	0.85	0.82	61,750
	6,267,025	3.16	$ 0.31	6,267,025

10. Warrants

The following table summarizes information about warrants outstanding as at:

	December 31, 2008			*December 31, 2007*		
	Number of warrants	*Exercise price*	*Fair value ascribed*	*Number of warrants*	*Exercise price*	*Fair value ascribed*
Opening	4,703,245	$ 0.17	$ 61,970	–	$ –	$ –
Issued	–	–	–	4,703,245	0.17	61,970
Exercised	(4,703,245)	(0.17)	(61,970)	–	–	–
Closing	–	$ –	$ –	4,703,245	$ 0.17	$ 61,970

11. Contributed surplus

	2008	*2007*
Balance, beginning of year	$ 1,808,044	$ 1,571,300
Stock-based compensation related to:		
Options granted in current year	595,610	76,847
Options granted in prior years	249,094	228,474
Unvested forfeited options	(16,774)	(68,577)
	827,930	236,744
Exercised options *(note 9(b)(iii))*	(178,542)	–
Repurchased shares *(note 9(b)(vi))*	93,965	–
Balance, end of year	$ 2,551,397	$ 1,808,044

Of the total $827,930 stock-based compensation recognized in 2008 (2007 – $236,744), $248,321 (2007 – $58,802) attributed to stock options granted to field personnel has been capitalized to property and equipment and the balance of $579,609 (2007 – $177,942) recorded as expense in the consolidated statement of operations.

12. 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:

	2008	*2007*
Loss before income taxes	$ (2,124,872)	$ (2,481,037)
Combined federal and provincial statutory income tax rate	29.50%	32.12%
Expected income tax reduction	$ (626,837)	$ (796,909)
Non-deductible charges	4,573	4,263
Stock-based compensation	170,985	57,155
Attributed Canadian Royalty Income	–	(20,342)
Utilization of non-capital losses	–	(45,664)
Rate adjustments	53,267	(292,074)
Other	98,220	(116,353)
	$ (299,792)	$ (1,209,924)

The components of the net future income asset (liability) at December 31 are:

	2008	*2007*
Asset retirement obligation	$ 531,061	$ 435,092
Non-capital and capital loss carryforwards	256,116	301,509
Share issue costs	9,416	72,227
Property and equipment	(2,553,738)	(2,673,562)
	$ (1,757,145)	$ (1,864,734)

As at December 31, 2008, the Company has approximately $31.8 million of tax pools available for deduction against future taxable income. The Company also has non-capital tax losses of $672,000 available for deduction against future taxable income that expire in 2009 and 2010.

13. Change in non-cash working capital

	2008	*2007*
Accounts receivable	$ (425,639)	$ 510,547
Prepaid expenses and deposits	(210,728)	22,302
Accounts payable and accrued liabilities	(91,473)	(1,877,339)
	$ (727,840)	$ (1,344,490)

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

	2008	*2007*
Operating	$ (428,503)	$ (415,775)
Financing	–	55,410
Investing	(299,337)	(984,125)
	$ (727,840)	$ (1,344,490)

14. Related party transactions

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

i) During the years ended December 31, 2008 and 2007, 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:

		2008		*2007*
Administration and consulting fees	$	137,858	$	123,498
Production and capital expenditures	$	249,493	$	148,326

ii) During the year ended December 31, 2008, the Company was charged $24,104 (2007 – $29,960) by a law firm in which a director of the Company is a partner.

Included in accounts payable and accrued liabilities at December 31, 2008 is $24,076 (2007 – $93,782) 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.

15. Financial instruments and financial risk management

The Company's financial instruments include accounts receivable, investment, bank indebtedness, accounts payable and accrued liabilities, bank debt, credit facility, and commodity price risk contracts (note 15(c)(iii)). The carrying values of accounts receivable, bank indebtedness, accounts payable and accrued liabilities, bank debt, and credit facility approximate their fair values due to their relatively short periods to maturity.

The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities. The Company has exposure to credit risk, liquidity risk and market risk as a result of its use of financial instruments. This note presents information about the Company's exposure to each of the above risks and the Company's objectives, policies and processes for measuring and managing these risks. Further quantitative disclosures are included throughout these financial statements.

The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with the risk management policies as set out herein:

a) Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. A substantial portion of the Company's accounts receivable are with natural gas and liquids marketers and joint venture partners in the oil and gas industry and are subject to normal industry credit risks. Purchasers of the Company's natural gas and liquids are subject to credit review to minimize the risk of non-payment. As at December 31, 2008, the maximum credit exposure is the carrying amount of the accounts receivable and accruals of $1,710,780 (December 31, 2007 – $1,285,141). As at December 31, 2008, the Company's receivables consisted of $1,055,449 from joint venture partners and other trade receivables and $655,331 of revenue receivable from petroleum and natural gas marketers.

15. Financial instruments and financial risk management (continued)

a) Credit risk (continued)

Receivables from petroleum and natural gas marketers are typically collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any significant collection issues with its petroleum and natural gas marketers. All of the $655,331 of revenue accruals and receivables from petroleum and natural gas marketers was received in January and February 2009.

Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company mitigates the risk from joint venture receivables by obtaining partner approval of capital expenditures prior to starting a project. However, the receivables are from participants in the petroleum and natural gas sector, and collection is dependent on typical industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. Further risk exists with joint venture partners as disagreements occasionally arise which increases the potential for non-collection.

For properties that are operated by the Company, production can be withheld from joint venture partners who are in default of amounts owing. In addition, the Company often has offsetting amounts payable to joint venture partners from which it can net receivable balances. As at December 31, 2008, the largest amount owing from one partner is $520,333 (see note 18).

The Company did not provide for any doubtful accounts nor was it required to write-off any receivables during the year ended December 31, 2008. The Company would only choose to write-off a receivable balance (as opposed to providing an allowance) after all reasonable avenues of collection had been exhausted.

As at December 31, 2008, the Company considers its receivables to be aged as follows:

Not past due	$ 852,888
Past due by less than 90 days	275,262
Past due by more than 90 days	582,630
	$ 1,710,780

b) Liquidity risk

Liquidity risk is the risk that the Company will incur difficulties meeting its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. The Company uses authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. To facilitate the capital expenditure program, the Company has a revolving reserve-based bank facility, as disclosed in note 6, which is reviewed quarterly by the lender. The Company monitors its total debt position monthly. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month. The Company anticipates it will have adequate liquidity to fund its financial liabilities through its future cash flows. The Company's financial liabilities are comprised of accounts payable and accrued liabilities, bank debt and the credit facility, both of which have expected maturities of less than one year resulting in their current classification on the balance sheet.

15. Financial instruments and financial risk management (continued)

c) Market risk

Market risk consists of interest rate risk, currency risk and commodity price risk. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Company may use both financial derivatives and physical delivery sales contracts to manage market risks. All such transactions are conducted in accordance with a risk management policy as set out herein:

i) Interest rate risk
Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its bank debt which bears interest at a floating rate. For the year ended December 31, 2008, if interest rates had been 1% lower with all other variables held constant, earnings for the period would have been $77,530 (2007 – $88,500) higher, respectively, due to lower interest expense. An equal and opposite impact would have occurred had interest rates been higher by the same amounts. The Company had no interest rate swap or financial contracts in place at December 31, 2008 and 2007.

ii) Currency risk
Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange rates. All of the Company's petroleum and natural gas sales are denominated in Canadian dollars; however, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. The Company had no outstanding forward exchange rate contracts in place at December 31, 2008 and 2007.

iii) Commodity price risk
Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand as well as the relationship between the Canadian and United States dollar, as outlined above.

In October 2008, the Company entered into a commodity price risk contract for the total notional quantity of 182,500 GJ of natural gas over the period January 1 to December 31, 2009 at a fixed price of $7.79 per GJ. In December 2008, the Company terminated the contract for proceeds of $226,800 based on the fair value of the contract on the settlement date.

During 2008, the Company fulfilled the following commodity price risk contracts for the sale of natural gas:

- 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;
- 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;
- 500 GJ per day from April 1 to August 31, 2008 at a ceiling price of $8.25 per GJ and a floor price of $7.00 per GJ; and
- 500 GJ per day from April 1 to August 31, 2008 at a ceiling price of $8.15 per GJ and a floor price of $7.50 per GJ.

15. Financial instruments and financial risk management (continued)

iii) Commodity price risk (continued)

During 2007, the Company fulfilled the following commodity price risk contracts for the sale of natural gas:

- 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 which was settled in July 2007 for proceeds of $244,800 based on the fair value of the contract on the settlement date; and
- 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.

See note 17 for commodity price risk contracts related to 2009 and 2010 natural gas sales.

16. Capital management

The Company's objective when managing capital is to maintain a flexible capital structure which will allow it to execute its capital expenditure program, which includes expenditures in oil and gas activities which may or may not be successful. Therefore, the Company monitors the level of risk incurred in its capital expenditures to balance the proportion of debt and equity in its capital structure.

The Company considers its capital structure to include its $13,599,207 working capital deficit (2007 – $12,834,528) and $24,452,012 (2007 – $24,012,759) of shareholders' equity. The Company monitors capital based on annual funds from operations and capital expenditure budgets, which are updated as necessary and are reviewed and periodically approved by the Company's Board of Directors. The Company manages its capital structure and makes adjustments by continually monitoring its business conditions including the current economic conditions, the risk characteristics of the Company's petroleum and natural gas assets, the depth of its investment opportunities, current and forecasted net debt levels, current and forecasted commodity prices and other facts that influence commodity prices and funds from operations such as quality and basis differentials, royalties, operating costs and transportation costs.

In order to maintain or adjust the capital structure, the Company considers its forecasted funds from operations while attempting to finance an acceptable capital expenditure program including acquisition opportunities, the current level of bank credit available from the Company's lender, the level of bank credit that may be attainable from its lender as a result of petroleum and natural gas reserve growth, the availability of other sources of debt with different characteristics than existing debt, the sale of assets, limiting the size of the capital expenditure program and the issue of new equity if available on favorable terms.

The Company's capital structure is not subject to external restrictions; however, the Company's bank facility is determined by the lender and based on the lender's borrowing base model which is based on the Company's petroleum and natural gas reserves.

There has been no change in the Company's approach to capital management during the year ended December 31, 2008. The Company has not paid or declared any dividends since the date of incorporation, nor are any contemplated in the foreseeable future.

17. Commitments

a) The Company has until December 31, 2009 to incur $600,000 of qualifying flow-through expenditures as disclosed in note 9(b)(v).

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

2009	$ 310,431
2010	178,655
2011	141,236
2012	141,236
2013	83,833

c) In February and March 2009, the Company committed to the following commodity price risk contracts for the sale of natural gas:

i) 1,500 GJ per day from April 1 to December 31, 2009 at a fixed price of $5.69 per GJ;

ii) 500 GJ per day from January 1 to December 31, 2010 at strike price of $6.25 per GJ;

iii) 500 GJ per day from January 1 to December 31, 2010 at strike price of $6.50 per GJ; and

iv) 500 GJ per day from January 1 to December 31, 2010 at strike price of $6.70 per GJ.

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.