

YANGARRA RESOURCES LTD.

MANAGEMENT'S DISCUSSION AND ANALYSIS

For the year ended December 31, 2008

Management's discussion and analysis ("MD&A") of the financial condition and the results of operations should be read in conjunction with the audited consolidated financial statements of Yangarra Resources Ltd. (the "Company") for the years ended December 31, 2008 and 2007, together with the accompanying notes. The MD&A has been prepared using information that is current to April 23, 2009.

The financial information presented herein has been prepared on the basis of Canadian generally accepted accounting principles ("GAAP"). Throughout this discussion, percentage changes are calculated using numbers rounded to the decimal to which they appear. All references to dollar amounts are in Canadian dollars.

BOE Presentation – *Production information is commonly reported in units of barrel of oil equivalent ("boe"). For purposes of computing such units, natural gas is converted to equivalent barrels of oil using a conversion factor of six thousand cubic feet to one barrel of oil. This conversion ratio of 6:1 is based on an energy equivalent wellhead value for the individual products. Such disclosure of boe may be misleading, particularly if used in isolation. Readers should be aware that historical results are not necessarily indicative of future performance.*

Special Note Regarding Non-GAAP Measures – *This MD&A includes references to financial measures commonly used in the oil and gas industry. The terms "**net petroleum and natural gas revenue**" (petroleum and natural gas sales less royalties, production expenses and transportation costs) and "**funds flow from operations**" (net loss for the period adjusted for non-cash items in the statement of operations) are not GAAP measures and do not have standardized meanings prescribed by GAAP.*

Forward-looking Statements – *Certain information regarding the Company set forth in this report, including management's assessment of the Company's future plans and operations, contain forward-looking statements that involve substantial known and unknown risks and uncertainties. These risks and uncertainties, many of which are beyond the Company's control, include the impact of general economic conditions and specific industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers, the lack of available qualified personnel or management, stock market volatility and ability to access sufficient capital from internal and external sources. The Company's actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements, and accordingly, no assurance can be given that any events anticipated by the forward-looking statements will transpire or occur, or if any of them do, what benefits the Company can derive such events.*

Company Description and Outlook

Yangarra Resources Ltd. ("Yangarra" or 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 the Ferrier, Medicine Hat, Mega, Viking, Jaslan and Bigstone areas of Alberta and in Bayhurst, Saskatchewan.

Yangarra has significantly reduced its finding and development (F&D) costs per boe over the past two years which can be attributed to the Company's strategy of exploiting already discovered reserves. F&D costs averaged \$55.22 per boe from 2004 to 2006 and were reduced to \$12.17 per boe in 2007 and \$18.23 per boe in 2008 including future capital on a proved plus probable basis.

With the rapid decline in the price of commodities, the price of natural gas in particular, Yangarra has elected to reduce capital expenditures to near zero until prices improve. In addition, the Company has entered into commodity swaps to provide a \$6.00 per mcf floor price for natural gas sales for more than

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50% of its production. This floor will ensure that Yangarra remains profitable on a cash basis until the end of 2009.

Yangarra is also pursuing farm out arrangements on some of its prospective properties which will allow the Company to utilize the new drilling incentives provided by the Alberta government; provide processing income from company-owned facilities; and ultimately achieve higher production with very little capital exposure.

During the year ended December 31, 2008, the Company's drilling program resulted in five successful gas wells drilled and cased in Medicine Hat and two successful gas wells in Jaslan.

Results of Operations

	Three months ended December 31			Year ended December 31		
	2008	2007	2006	2008	2007	2006
Statement of Operations and Deficit						
Petroleum & natural gas sales (\$)	1,806,264	1,443,695	2,381,251	8,642,336	7,899,634	9,439,251
Petroleum & natural gas sales per boe (\$)	43.71	43.17	44.02	51.03	45.10	43.33
Net petroleum & natural gas revenue (\$)	1,023,858	1,072,194	1,905,553	5,483,741	5,688,637	6,238,311
Net petroleum & natural gas revenue per boe (\$)	24.78	32.06	35.23	32.38	32.48	28.64
Daily sales volumes (boe 6:1)	449	362	588	463	480	597
Net income (loss) for the period (\$)	(574,791)	64,089	(884,912)	(1,825,080)	(1,271,113)	(1,963,139)
Net income (loss) per share – basic (\$)	(0.01)	–	(0.02)	(0.03)	(0.02)	(0.04)
Statement of Cash Flows						
Funds flow from operations (\$)	936,560	594,704	1,222,746	3,820,278	3,504,225	4,102,713
Balance Sheet						
Property and equipment (\$)	41,922,138	40,371,767	46,012,569	41,922,138	40,371,767	46,012,569
Total assets (\$)	44,081,309	42,009,723	48,281,762	44,081,309	42,009,723	48,281,762
Weighted average number of shares – basic						
	70,499,738	61,555,766	53,989,674	67,499,983	55,896,744	53,759,207

Net petroleum and natural gas revenue

	Three months ended December 31		Year ended December 31	
	2008	2007	2008	2007
Net petroleum & natural gas revenue	\$ 1,023,858	\$ 1,072,194	\$ 5,483,741	\$ 5,688,637
Per boe	\$ 24.78	\$ 32.06	\$ 32.38	\$ 32.48

The variances in net petroleum and natural gas revenue are explained by changes in the following components:

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	Three months ended		Year ended	
	December 31		December 31	
	2008	2007	2008	2007
Total boe (boe 6:1)	41,324	33,441	169,348	175,155
Daily sales volumes (boe 6:1)	449	362	463	480
Petroleum & natural gas sales	\$ 1,806,264	\$ 1,443,695	\$ 8,642,336	\$ 7,899,964
Per boe	\$ 43.71	\$ 43.17	\$ 51.03	\$ 45.10
Royalties	\$ 162,048	\$ 130,294	\$ 1,329,490	\$ 1,039,249
Per boe	\$ 3.92	\$ 3.90	\$ 7.85	\$ 5.93
As a % of sales	9%	9%	15%	13%
Production & transportation costs	\$ 620,358	\$ 241,207	\$ 1,829,105	\$ 1,172,078
Per boe	\$ 15.01	\$ 7.21	\$ 10.80	\$ 6.69

- The reduction in daily production for the year ended December 31, 2008 as compared to the 2007 period can be attributed to the sale of Mundare in July 2007 and Provost in March 2008 as well as the effects of natural declines in other areas. The declines were partially offset by two new wells drilled in the Jaslan area which came on production in January and November 2008 and new production in Medicine Hat which came on at the end of March 2008.
- The average price earned by the Company increased in 2008 due to increases in all commodity prices for the first six to eight months of the year. The largest price increases were for oil and natural gas liquids (“NGLs”) which make up approximately 10% of the Company’s production. For 2008, the Company’s average oil price was \$102.92/bbl and the average for NGLs was \$73.47/bbl (2007 – oil \$73.71/bbl; NGLs \$55.64/bbl). Natural gas prices earned in 2008 were also higher at \$7.92/mcf for the 2008 period versus \$7.22/mcf for 2007.
- Petroleum and natural gas sales for the three months and year ended December 31, 2008 include a \$138,840 realized gain and a \$211,008 realized loss, respectively, (three months and year ended December 31, 2007 – realized gains of \$120,905 and \$270,508, respectively) on commodity contracts in place during the year.
- The increase in royalties for the 2008 year on both a boe and percentage basis relates to new production in Medicine Hat for which the production is at a higher level and therefore attracts a higher royalty rate. Royalty rates were also higher earlier in the year due to increases in natural gas prices.
- The low production and transportation costs for the 2007 year were primarily due to recoveries of prior year(s) operating costs resulting from the settlement of a joint venture audit of Ferrier operating costs performed by the Company in 2005 as well as facility equalization related to prior years. Removing the effects of these adjustments, production and transportation costs for the year ended December 31, 2007 were \$9.46/boe. The increase in year-over-year operating costs per boe is due to higher operating costs in the fourth quarter of 2008.
- Production and transportation costs per boe for the fourth quarter of 2008 increased due to additional trucking, maintenance and chemical costs in the Medicine Hat area as well as higher fixed costs per boe due to natural production declines in Ferrier, Viking and older Jaslan wells.

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Depletion, depreciation and accretion

	Three months ended December 31		Year ended December 31	
	2008	2007	2008	2007
Depletion and depreciation	\$ 1,466,950	\$ 1,026,331	\$ 4,797,322	\$ 5,743,923
Per boe	\$ 35.50	\$ 30.69	\$ 28.33	\$ 32.79
Accretion	\$ 31,745	\$ 25,691	\$ 125,069	\$ 104,310

The depletion rate for the three months ended December 31, 2008 is higher as compared to the three months ended December 31, 2007 due to a decrease in the Company's proved reserves as stated in the Company's December 31, 2008 independent reserve report. Although the Company had considerable success with the Jaslan Wabamun play, the Jaslan reserve additions were offset by reductions proved reserves in previously evaluated areas and current year production. Reductions were primarily due to unexpectedly low pool pressure indications in Ferrier and premature watering out of a gas reservoir in Medicine Hat. The reserve loss in Medicine Hat is expected to be a temporary setback until the Company can demonstrate that the related production can be turned back on through the drilling of new wells or the remediation of old wells.

The annual depletion rate is lower in 2008 due to calculations for the first three quarters based on the 2007 reserve report and management's estimates of proved reserves added those periods.

Accretion expense increased in 2008 due to an increase in the undiscounted cash flows associated with the retirement of the Company's assets resulting from the increase in the number of properties and changes to certain reserve life and cost estimates.

Other expenses

	Three months ended December 31		Year ended December 31	
	2008	2007	2008	2007
General and administrative expenses	\$ 68,412	\$ 330,902	\$ 813,314	\$ 1,106,879
Interest and financing fees	\$ 474,948	\$ 211,400	\$ 1,404,947	\$ 1,423,942
Stock-based compensation	\$ (7,712)	\$ 52,565	\$ 579,609	\$ 177,942

General and administrative expenses were lower in 2008 due to management's continued efforts to monitor and reduce costs. During the fourth quarter of 2008, management undertook an extensive review of charges for 2008 consulting services and capitalized fees for work performed on specific exploration and development projects.

Interest and financing fees for the three month and year ended periods include:

- Interest in 2008 of \$101,282 and \$464,916, respectively, on the revolving operating demand loan for which the average amount drawn during 2008 was \$7,875,000 at an effective interest rate of 5.7% compared to \$138,168 and \$657,527, respectively, in the 2007 periods on an average loan balance of \$8,850,000 at an effective interest rate of 7.2%; and
- Interest and financing fees on the credit facility based on the effective interest method of \$193,444 and \$760,790, respectively plus a deferred fee of \$180,000 related to the maturity of the 2008 credit

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facility for the 2008 periods compared to interest and financing fees of \$149,372 and \$764,783, respectively, for the 2007 periods.

Total stock based compensation ("SBC") recorded in the three months and year ended December 31, 2008 periods, was a net recovery of \$5,757 and expense of \$827,930, respectively. Of the total, \$1,955 and \$248,321, respectively, was attributed to stock options granted to field personnel and capitalized to property and equipment. The remaining SBC for the three months and year ended December 31, 2008 was a \$7,712 recovery and a \$579,609 expense, respectively, as reported in the consolidated statements of operations. The net recovery of SBC in the fourth quarter is due to the reversal of previously recorded SBC related to unvested options forfeited in the period. Options were granted in the first and second quarters of 2008. These options vested immediately resulting in all of the estimated fair value being recognized as SBC on the grant date.

In the three month and year ended periods of 2007, a total of \$66,430 and \$236,744, respectively, was recognized for stock-based compensation ("SBC"). Of the total, \$13,865 and \$58,802, respectively, was attributed to stock options granted to field personnel and capitalized to property and equipment. The remaining SBC for the three months and year ended December 31, 2007 was an expense of \$52,565 and \$177,942, respectively.

Financial instruments

	Three months ended December 31		Year ended December 31	
	2008	2007	2008	2007
Other income (loss)				
Commodity contract settlement	\$ (226,800)	\$ -	\$ (226,800)	\$ (244,800)
Change in fair value of commodity contracts	\$ 76,940	\$ 76,639	\$ -	\$ -
	\$ (149,860)	\$ 76,639	\$ (226,800)	\$ (244,800)
Loss (gain) on investment	\$ 13,958	\$ (102,759)	\$ 115,152	\$ (142,522)

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. In 2007, the Company received \$244,800 of proceeds related to the unwinding of a portion of a 2007 commodity price risk contract in July 2007.

In February 2008, the Company entered into four commodity collars for the sale of natural gas at prices between \$8.46 per GJ and \$7.00 per GJ (see Financial Instruments section). As at December 31, 2008, the collars had been fulfilled. The change in fair value of commodity contracts for the fourth quarter of 2008 relates to the reversal of the \$76,940 gain for the mark-to-market value of the unfulfilled portion of the contracts in effect at September 30, 2008. The mark-to-market value represents what the Company would have to pay (liability) or receive (asset) if the contracts were terminated on the measurement date.

In 2007, the Company was committed to two European commodity collars for the sale of natural gas at prices between \$10.00 per GJ and \$7.00 per GJ for which the net mark-to-market value of the unfulfilled portion of the contracts at September 30, 2007 was an asset of \$143,959 and the related gain, net of \$67,320 of contract premiums.

The unrealized loss (gain) on investment relates to a minority equity position in a public company. As at December 31, 2008, the fair value of the Company's investment was \$10,468 (December 31, 2007 –

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\$125,620). The change in fair value at each balance sheet date has been reported as an unrealized gain/loss on investment in the consolidated statement of operations. In 2007, the Company reported a gain of \$142,522 comprised 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.

Future income tax recovery

During the year ended December 31, 2008, the Company recorded a \$299,792 recovery of future income taxes compared to the \$1,209,924 recovery recorded in 2007. The decrease in the recovery is due to a reduction in the loss for tax purposes at a lower future tax rate. In addition, the 2007 recovery included the effect of tax rate reductions announced in the 2007 federal budget.

Liquidity and Capital Resources

During the three months and year ended December 31, 2008, the Company generated \$936,560 and \$3,820,278, respectively, of funds flow from operations compared to \$594,704 and \$3,504,225, respectively, in the 2007 comparative periods. The improvement in funds flow from operations is primarily due to lower general and administrative expenses and a decrease in interest paid in the year (interest and financing fees less the non-cash effect of amortization for the effective interest rate method).

As at December 31, 2008, the Company's revolving operating demand loan was available to a maximum of \$9,000,000, of which the Company had drawn \$8,150,000. The Company is subject to a working capital covenant for the revolving operating demand loan which was met at December 31, 2008.

As at December 31, 2008, the Company had a \$4,500,000 credit facility (the "2008 facility") bearing interest at 12% 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 will be netted against the principal amount of the credit facility and amortized to interest over the term of the 2009 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. As at December 31, 2008, the Company was in breach of the debt to trailing cash flow covenant and received acknowledgement of the breach from the lender.

In March 2008, certain shareholders, who are also officers and directors of the Company, advanced the Company \$250,000. The advances were settled in lieu of cash proceeds payable to the Company on the exercise of 1,470,588 warrants at various dates in the second quarter.

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.

As at December 31, 2008, the Company had a working capital deficit of \$13,599,207 compared to a deficit of \$12,834,528 at December 31, 2007. The increase in the working capital deficit was due to \$3,820,278 of funds flow generated by operating activities, \$250,000 of loans from shareholders applied against warrant proceeds (as noted above), \$1,301,464 of net cash proceeds from the exercise of warrants

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and stock options and the December 2008 issuance of flow-through shares and \$78,776 of disposition proceeds related to Provost properties sold in March 2008 offset by \$5,770,571 of capital spending, \$50,633 for the repurchase of 300,000 common shares of the Company and \$393,993 related to the amortized cost and 4% deferred fee on the credit facility.

Capital Spending

During the three months and year ended December 31, 2008, the Company spent \$1,746,478 and \$5,770,571, respectively, on its capital spending program compared to \$1,056,487 and \$3,267,994, respectively, for the three months and year ended December 31, 2007.

Capital spending is summarized as follows:

	Three months ended December 31		Year ended December 31	
	2008	2007	2008	2007
Land and lease rentals	\$ 137,485	\$ 55,970	\$ 843,539	\$ 167,480
Drilling and completion	585,577	655,171	3,086,664	1,565,066
Geological and geophysical	163,109	8,955	213,951	204,603
Equipment	860,307	336,391	1,626,417	1,330,845
	1,746,478	1,056,487	5,770,571	3,267,994
Dispositions	(28,776)	(577,000)	(78,776)	(3,430,734)
	\$ 1,717,702	\$ 479,487	\$ 5,691,795	\$ (162,740)

2008 drilling activity

	Three months ended December 31, 2008		Year ended December 31, 2008	
	Gross	Net	Gross	Net
Natural gas	1	1	7	7
Re-entry (gas)	-	-	-	-
Dry	-	-	-	-
	1	1	7	7

Asset retirement obligation

As at December 31, 2008, the undiscounted fair value of the asset retirement obligation associated with the Company's existing properties was estimated to be \$4,450,264 for which \$2,124,242 has been recorded using a discount rate of 7% - 12%, an inflation rate of 2% and an estimated weighted average timing of cash flows of 11.5 years.

Related Party Transactions

During the years ended December 31, 2008 and 2007, the Company's related party transactions consisted of:

i)

	<i>2008</i>	<i>2007</i>
Administration and consulting fees	\$ 137,858	\$ 123,498
Production and capital expenditures	\$ 249,493	\$ 148,326

The above amounts were charged or invoiced by certain of its officers and directors and by companies controlled by certain of the Company's officers and directors.

ii) \$24,104 (2007 – \$29,960) of legal fees charged by a law firm in which a director of the Company is a partner.

Share Capital

Common shares

The Company commenced 2008 with a total of 63,396,167 issued and outstanding shares with a book value of \$32,533,251. During 2008, the Company issued 450,000 common shares as settlement of a long-term payable in respect of certain credit facility fees; 1,312,500 common shares on the exercise of stock options; 4,703,245 common shares on the exercise of warrants and 6,000,000 common shares through a private placement. In the third and fourth quarters of 2008, the Company repurchased 300,000 of its common shares pursuant to a normal course issuer bid. As at December 31, 2008 and the date of this MD&A, there were 75,561,912 issued and outstanding common shares with a book value of \$34,116,201.

Warrants

As at December 31 2007, the Company had 4,703,245 warrants outstanding. During the second quarter of 2008, all of the warrants were exercised. As at December 31, 2008 and the date of this MD&A, there were no warrants outstanding.

Stock options

As at December 31, 2007, there were 4,137,275 stock options outstanding, of which 2,412,275 were exercisable. During 2008, 3,750,000 stock options were granted, 1,312,500 stock options were exercised, 232,750 stock options expired and 75,000 stock options were forfeited. As at December 31, 2008 and the date of this MD&A, the Company had 6,267,025 stock options outstanding all of which are exercisable.

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 was made in the financial statements at December 31, 2008 or 2007.

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Commitments

- a) The Company has until December 31, 2009 to incur \$600,000 of qualifying flow-through expenditures related to the issue of 6,000,000 common shares on a flow-through basis issued in December 2008.
- 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:
- 1,500 GJ per day from April 1 to December 31, 2009 at a fixed price of \$5.69 per GJ;
 - 500 GJ per day from January 1 to December 31, 2010 at strike price of \$6.25 per GJ;
 - 500 GJ per day from January 1 to December 31, 2010 at strike price of \$6.50 per GJ; and
 - 500 GJ per day from January 1 to December 31, 2010 at strike price of \$6.70 per GJ.

Financial Instruments

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. 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 reported amount for the Company's investment at December 31, 2008 is at market value.

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.

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

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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:

b) 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.

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 Contingency).

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
	\$	<u>1,710,780</u>

c) Liquidity Risk

Liquidity risk is the risk that the Company will incur difficulties meeting its financial obligations as

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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 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.

d) 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 under Currency Risk.

During 2008, the Company fulfilled the commodity price risk contracts as described above. In February 2009, the Company entered into commodity price risk contracts for 2009 and 2010 production as described under Commitments.

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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.

Selected Historical Financial Information

2008	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Petroleum and natural gas sales	2,104,060	2,661,004	2,071,008	1,806,264
Net petroleum and natural gas revenue	1,427,515	1,744,759	1,287,609	1,023,858
Net income (loss)	(1,045,274)	(1,076,877)	871,862	(574,791)
Net income (loss) per share	(0.02)	(0.02)	0.01	(0.01)
Funds flow from operations	944,104	1,214,745	724,869	936,560
Net capital expenditures	1,017,265	1,513,100	1,443,728	1,717,702

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2007	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Petroleum and natural gas sales	2,606,074	2,256,132	1,594,063	1,443,695
Net petroleum and natural gas revenue	1,889,356	1,796,580	930,507	1,072,194
Net income (loss)	(868,562)	(32,886)	(433,754)	64,089
Net income (loss) per share	(0.02)	–	(0.01)	–
Funds flow from operations	1,281,607	1,138,801	489,113	594,704
Net capital expenditures (proceeds)	1,378,362	430,456	(2,451,045)	479,487

Business Risks and Uncertainties

The Company is exposed to several operational risks inherent in exploring, developing, producing and marketing crude oil and natural gas. These inherent risks include: economic risk of finding and producing reserves at a reasonable cost; financial risk of marketing reserves at an acceptable price given current market conditions; cost of capital risk associated with securing the needed capital to carry out the Company's operations; risk of environment impact and credit risk of non-payment for sales contracts and joint venture partners.

The Company attempts to control operating risks by maintaining a disciplined approach to implementation of its exploration and development programs. Exploration risks are managed by hiring experienced technical professionals and by concentrating the exploration activity on specific core regions that have multi-zone potential where the Company has experience and expertise. The Company also generates internal prospects and participates in projects where ownership interest is considered sufficient to minimize risk. Operational control allows the Company to manage costs, timing and sales of production and to ensure new production is brought on-stream in a timely manner.

The Company maintains a comprehensive insurance program to reduce risk to an acceptable level and to protect it against significant losses. The Company's risk in regards to financial instruments is detailed in note 19 to the annual consolidated financial statements.

Disclosure Controls and Procedures

In connection with Exemption Orders issued in November 2007 by each of the securities commissions across Canada, the Company's certifying officers will file a Venture Issuer Basic Certificate with respect to the financial information contained in the unaudited interim financial statements and the audited annual financial statements and respective accompanying Management's Discussion and Analysis. The Venture Issuer Basic Certification includes a 'Notice to Reader' stating that the certifying officers do not make any representations relating to the establishment and maintenance of disclosure controls and procedures and internal control over financial reporting, as defined in National Instrument 52-109 – Certification of Disclosure in Issuers' Annual and Interim Filings.

Critical Accounting Estimates

The Company's financial statements are prepared in accordance with Canadian generally accepted accounting principles. A comprehensive discussion of the Company's significant accounting policies is contained in Notes 2 and 3 to the audited consolidated financial statements for the year ended December 31,

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2008. The Company's significant accounting policies are subject to estimates and key judgments about future events, many of which are beyond management's control.

The Company believes the following are the most critical accounting estimates used in the determination of its financial results:

Petroleum and natural gas properties – depletion and ceiling test

The Company follows the full cost method of accounting by initially capitalizing all costs related to the acquisition, development and exploration of petroleum and natural gas reserves. Costs capitalized include land acquisition costs, geological and geophysical expenditures, rentals on undeveloped properties, costs of drilling productive and non-productive wells, together with overhead directly related to exploration and development activities and lease and well equipment. Costs capitalized are depleted using the unit-of-production method based on gross proved petroleum and natural gas reserves as determined by independent qualified reserve evaluators. Production and reserves of petroleum and natural gas are converted to common units of measure based on their relative energy content where one barrel of oil is equivalent to six thousand cubic feet of natural gas. The depletion base excludes the cost of significant unproved properties until it is determined whether proved reserves are attributable to the properties or impairment has occurred.

The Company performs a ceiling test the carrying amount of property and equipment is compared to the sum of the undiscounted cash flows expected to result from the future production of proved and probable reserves and the cost, less any impairment of unproved properties. Estimated cash flows are discounted at the Company's risk-free rate of interest using forecast prices and costs. The carrying amount of undeveloped properties and seismic excluded from the ceiling test are compared to independent evaluations of fair value. Any impairment is recorded as additional depletion expense.

Estimates are the basis for amounts recorded as depletion and the ceiling test. These estimates include proved and probable reserves, production rates, future petroleum and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates could be material in future periods.

Asset retirement obligation

The Company recognizes the liability for the asset retirement obligation associated with the abandonment of petroleum and natural gas wells, related facilities, compressors and plants and the removal of equipment from leased acreage and returning such land to its original condition. The fair value the Company's asset retirement obligation is recorded in the period a well or related asset is drilled, constructed or acquired. Fair value is estimated using the present value of the estimated future cash outflows to abandon the assets at the Company's credit-adjusted risk-free interest rate based on the expected timing of such cash outflows. Future costs and their expected timing are estimates that are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates could be material in future periods.

Income taxes

The Company records future tax assets and liabilities to account for the expected future tax consequences of events that have been recorded in its consolidated financial statements and its tax returns. These amounts are estimates and the actual tax consequences may differ from the estimates due to changing tax rates and regimes, as well as changing estimates of cash flows and capital expenditures in current and future periods. A valuation allowance is recorded to the extent that there is uncertainty regarding utilization of future tax assets.

The determination of the Company's income and other tax liabilities requires interpretation of complex laws and regulations, often involving multiple jurisdictions. All tax filings are subject to audit and potential

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reassessment after the lapse of considerable time. Accordingly, the actual income tax liability and expense may differ from that estimated and recorded.

Stock-based compensation

Stock-based compensation expense is recorded in the statement of loss and deficit for all options granted based on the estimated fair value at the time of the grant and recognized as expense over the vesting period of the option. The fair value of options is estimated using the Black-Scholes pricing model based on estimates and assumptions for expected life of the options, expected volatility, risk-free interest rate and dividend yield. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates could be material in future periods.

Changes in Accounting Policies

On January 1, 2008, the Company adopted the new Canadian accounting standards for *Section 1535 Capital Disclosures*, *Section 3862 Financial Instruments – Disclosure* and *Section 3863 Financial Instruments – Presentation* and amendments to standards dealing with reclassification of financial assets as disclosed in note 3 of the Company's December 31, 2008 audited consolidated financial statements. Adopting these standards did not impact the Company's consolidated financial statements.

In addition, the Company is currently assessing the impact of:

		Effective for Annual Periods Beginning on or After
Section 1000	Financial Statement Concepts (amended)	January 1, 2009
Section 3064	Goodwill and Intangible Assets	January 1, 2009
AcG 11	Enterprises in the Development Stage (amended)	January 1, 2009
Section 1582	Business Combinations	January 1, 2011
Section 1601	Consolidations	January 1, 2011
Section 1602	Non-controlling Interests	January 1, 2011

In addition, the Canadian Accounting Standards Board (AcSB) published a new strategic plan that outlines the convergence of Canadian generally accepted accounting principles with International Financial Reporting Standards ("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.