# Yangarra Resources Ltd.

## Interim Consolidated Financial Statements

*Three and six months ended June 30, 2009 and 2008*

*(Unaudited – Prepared by Management)*

## Notice of No Auditor Review of Interim Consolidated Financial Statements

In accordance with National Instrument 51-102 released by the Canadian Securities Administrators, the Company discloses that its auditors have not reviewed these unaudited interim consolidated financial statements as at and for the three and six months ended June 30, 2009 and 2008.

## Yangarra Resources Ltd.
### Interim Consolidated Balance Sheets
*(unaudited)*

| | | June 30 2009 | | December 31 2008 |
|---|---|---|---|---|
| **Assets** | | | | |
| Current | | | | |
| Accounts receivable | $ | **1,308,032** | $ | 1,710,780 |
| Prepaid expenses and deposits | | **463,234** | | 437,923 |
| Commodity price risk contracts *(note 14(c)(iii))* | | **135,343** | | – |
| | | **1,906,609** | | 2,148,703 |
| Investment *(note 3)* | | **–** | | 10,468 |
| Property and equipment *(note 4)* | | **40,330,298** | | 41,922,138 |
| | $ | **42,236,907** | $ | 44,081,309 |
| **Liabilities** | | | | |
| Current | | | | |
| Bank debt *(note 5)* | $ | **8,792,417** | $ | 8,853,990 |
| Credit facility *(note 6)* | | **4,447,835** | | 4,665,000 |
| Accounts payable and accrued liabilities *(note 16)* | | **1,966,762** | | 2,228,920 |
| | | **15,207,014** | | 15,747,910 |
| Asset retirement obligation *(note 7)* | | **2,176,870** | | 2,124,242 |
| Future income tax liability *(note 8)* | | **1,587,165** | | 1,757,145 |
| Long-term payable *(notes 9 and 16)* | | **126,687** | | – |
| | | **19,097,736** | | 19,629,297 |
| **Shareholders' Equity** | | | | |
| Share capital *(note 10)* | | **33,966,201** | | 34,116,201 |
| Contributed surplus | | **2,551,397** | | 2,551,397 |
| Deficit | | **(13,378,427)** | | (12,215,586) |
| | | **23,139,171** | | 24,452,012 |
| | $ | **42,236,907** | $ | 44,081,309 |

Future operations and basis of presentation *(note 1)*
Subsequent events *(note 16)*
Commitments *(note 17)*

*The accompanying notes are an integral part of these interim consolidated financial statements*

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2009** | 2008 | **2009** | 2008 |
| **Revenue** | | | | |
| Petroleum and natural gas sales *(note 14(c)(iii))* | $ **909,592** | $ 2,661,004 | $ **1,935,561** | $ 4,765,064 |
| Royalties | **(15,695)** | (474,228) | **(79,426)** | (791,916) |
| Royalty recoveries *(note 11)* | **–** | – | **175,636** | – |
| | **893,897** | 2,186,776 | **2,031,771** | 3,973,148 |
| Interest | **10,855** | – | **10,855** | – |
| Unrealized gain (loss) on commodity price risk contracts *(note 14(c)(iii))* | **34,047** | (688,554) | **135,343** | (1,202,356) |
| | **938,799** | 1,498,222 | **2,177,969** | 2,770,792 |
| **Expenses** | | | | |
| Production | **327,378** | 392,530 | **629,895** | 706,772 |
| Transportation | **33,070** | 49,487 | **62,820** | 94,102 |
| General and administrative | **238,007** | 277,463 | **385,837** | 500,881 |
| Interest and financing fees | **250,401** | 306,595 | **502,181** | 614,306 |
| Stock-based compensation | **–** | 384,047 | **–** | 571,636 |
| Depletion and depreciation | **985,474** | 1,097,532 | **2,030,848** | 2,268,262 |
| Accretion | **36,174** | 30,457 | **72,410** | 60,914 |
| (Gain) loss on investment *(note 3)* | **(16,222)** | 36,988 | **(23,201)** | 76,070 |
| | **1,854,282** | 2,575,099 | **3,660,790** | 4,892,943 |
| **Loss before income taxes** | **(915,483)** | (1,076,877) | **(1,482,821)** | (2,122,151) |
| Future income tax reduction *(note 8)* | **(157,692)** | – | **(319,980)** | – |
| **Net loss and comprehensive loss for the period** | **(757,791)** | (1,076,877) | **(1,162,841)** | (2,122,151) |
| Deficit, beginning of period | **(12,620,636)** | (11,435,780) | **(12,215,586)** | (10,390,506) |
| **Deficit, end of period** | $ **(13,378,427)** | $ (12,512,657) | $ **(13,378,427)** | $ (12,512,657) |
| **Loss per share** | | | | |
| Basic and diluted [(1)] | $ **(0.01)** | $ (0.02) | $ **(0.02)** | $ (0.03) |
| **Weighted average number of shares** | | | | |
| Basic | **75,561,912** | 65,844,189 | **75,561,912** | 64,832,815 |
| Diluted | **75,561,912** | 66,721,261 | **75,561,912** | 65,212,883 |

[(1)] The effect of options is anti-dilutive in loss periods.

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2009** | 2008 | **2009** | 2008 |
| **Operating** | | | | |
| Net loss for the period | $ **(757,791)** | $ (1,076,877) | $ **(1,162,841)** | $ (2,122,151) |
| Add back non-cash items: | | | | |
| Unrealized (gain) loss on commodity price risk contracts | **(34,047)** | 688,554 | **(135,343)** | 1,202,356 |
| Interest and financing fees | **127,646** | 54,044 | **154,322** | 101,762 |
| Shares issued for services *(note 9)* | **25,200** | – | **25,200** | – |
| Stock-based compensation | **–** | 384,047 | **–** | 571,636 |
| Depletion and depreciation | **985,474** | 1,097,532 | **2,030,848** | 2,268,262 |
| Accretion | **36,174** | 30,457 | **72,410** | 60,914 |
| (Gain) loss on investment | **(16,222)** | 36,988 | **(23,201)** | 76,070 |
| Future income tax reduction | **(157,692)** | – | **(319,980)** | – |
| Abandonment expenditures *(note 7)* | **(27,879)** | – | **(27,879)** | – |
| | **180,863** | 1,214,745 | **613,536** | 2,158,849 |
| Change in non-cash working capital *(note 12)* | **117,728** | (90,571) | **99,597** | (202,549) |
| | **298,591** | 1,124,174 | **713,133** | 1,956,300 |
| **Financing** | | | | |
| Issue of equity instruments, net of costs | **–** | 700,318 | **–** | 700,318 |
| Bank debt (repayment) proceeds, net | **(287,249)** | (584,946) | **(61,573)** | 279,906 |
| Financing fees | **–** | – | **(270,000)** | (45,000) |
| Related party advance | **–** | – | **–** | 250,000 |
| | **(287,249)** | 115,372 | **(331,573)** | 1,185,224 |
| **Investing** | | | | |
| Expenditures on property and equipment | **(132,898)** | (1,513,100) | **(430,911)** | (2,580,365) |
| Proceeds on disposition of property and equipment | **–** | – | **–** | 50,000 |
| Proceeds on sale of investment | **33,669** | | **33,669** | |
| Change in non-cash working capital *(note 12)* | **87,887** | 273,554 | **15,682** | (611,159) |
| | **(11,342)** | (1,239,546) | **(381,560)** | (3,141,524) |
| **Increase (decrease) in cash** | **–** | – | **–** | – |
| Cash, beginning of period | **–** | – | **–** | – |
| **Cash, end of period** | $ **–** | $ – | $ **–** | $ – |
| **Supplemental cash flow information** | | | | |
| Interest paid | $ **118,628** | $ 246,814 | $ **352,143** | $ 504,231 |

*The accompanying notes are an integral part of these interim consolidated financial statements*

## 1. Future operations and basis of presentation

Yangarra Resources Ltd. (the "Company") is a publicly traded company involved in the production, exploration and development of resource properties in Western Canada. These unaudited interim 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.

These unaudited interim 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. 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, negotiate favorable terms with its lenders and obtain capital financing from investors sufficient to meet current and future obligations.

As at June 30, 2009, the Company had a working capital deficiency of $13,300,405 (December 31, 2008 – $13,599,207) and an accumulated deficit of $13,378,427 (December 31, 2008 – $12,215,586). At the same time, the Company continues to generate positive cash flow from operations. The Company's bank debt (note 5) and credit facility (note 6) were renewed in June 2009. The renewal of bank debt is in the form of a Forbearance Agreement (the "Agreement") and includes several additional covenants with respect to production levels, capital expenditures, drilling programs and certain other expenses and requirements as outlined in note 5.

Management has addressed the Company's ability to continue as a going concern as follows:

a) Operating cash flows are projected to be positive in the current oil and gas price environment but are not sufficient to support significant investment in the development of the Company's properties during the balance of the fiscal 2009 year. The Company has restricted capital projects for the 2009 year to closely match the cash flows generated from operations.

b) The Company has contacted its unsecured creditors to extend repayment terms or settle accounts payable in common shares at $0.06 per share. In June 2009, the Company reached extended repayment terms for approximately $1,143,500 of accounts payable. In August 2009, the Company issued 4,680,873 common shares for the settlement of $280,847 of accounts payable (note 16 (d)).

c) Pursuant to the Agreement, the Company has retained an agent for the sale of as many assets as required to generate cash for the reduction of bank debt. The sale process will commence on September 1, 2009.

d) Pursuant to the Agreement, the Company has commenced a two well drilling program to increase production levels and generate additional cash flow from operations.

e) Pursuant to the Agreement, the Company has engaged a consultant to monitor the Company's operations.

f) The Company continues its efforts to reduce general and administrative expenses.

There can be no assurance that the steps management is taking will be successful and any adjustments necessary to the financial statements if the Company ceases to be a going concern could be material.

These unaudited interim consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and on a basis consistent with the audited December 31, 2008 consolidated financial statements except certain disclosures have been condensed or omitted. Accordingly, these unaudited interim consolidated financial statements should be read in conjunction with the notes contained in the Company's audited December 31, 2008 consolidated financial statements.

## 1. Future operations and basis of presentation (continued)

Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of periodic financial statements necessarily involves the use of estimates and approximations. Accordingly, actual results could differ from those estimates.

The operating results for the three and six months ended June 30, 2009 may not be indicative of the results for the year ended December 31, 2009.

## 2. Change in accounting policies

On January 1, 2009, the Company adopted the Canadian Institute of Chartered Accountants Handbook *Section 3064 Goodwill and Intangible Assets* which replaces the previous goodwill and intangible asset standard and revises the requirement for recognition, measurement, presentation and disclosure of intangible assets. The adoption of this standard had no impact on the Company's unaudited interim consolidated financial statements.

## 3. Investment

The Company held a minority equity position in a public company which was sold in May 2009 for cash proceeds of $33,669. The reported amount of (gain) loss on investment for the three and six months ended June 30, 2009 and 2008 is comprised of the following:

| | *Three months ended June 30* | | *Six months ended June 30* | |
|---|---|---|---|---|
| | *2009* | *2008* | *2009* | *2008* |
| Realized loss | $ 231,638 | $ – | $ 231,638 | $ – |
| Reversal of previously recognized unrealized net losses | (240,881) | – | (254,839) | – |
| Unrealized (gain) loss on mark-to-market | (6,979) | 36,998 | – | 76,070 |
| | $ (16,222) | $ 36,998 | $ (23,201) | $ 76,070 |

## 4. Property and equipment

| *June 30, 2009* | *Cost* | *Accumulated depletion and depreciation* | *Net book value* |
|---|---|---|---|
| Petroleum and natural gas properties | $ 65,600,981 | $ 25,357,091 | $ 40,243,890 |
| Office equipment | 279,281 | 192,873 | 86,408 |
| | $ 65,880,262 | $ 25,549,964 | $ 40,330,298 |

| *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 |

## 4. Property and equipment (continued)

At June 30, 2009, the Company excluded $1,489,755 (December 31, 2008 – $1,773,042) of resource properties relating to unproved properties from the depletion calculation. Unproved properties have been separately evaluated by management for impairment. In addition, $7,520,000 (December 31, 2008 – $7,886,400) of future development costs were included in the depletion calculation.

During the three and six months ended June 30, 2009, the Company capitalized nil (three and six months ended June 30, 2008 – $243,987 and $316,606, respectively, comprised of stock-based compensation of $182,990 and $237,454, respectively, and $60,997 and $79,152, respectively, of related future income taxes) for options granted to field consultants. The Company also capitalized $2,428 and $14,101, respectively, (three and six months ended June 30, 2008 – 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.

## 5. Bank debt

In June 2009, the Company renewed the revolving operating demand loan with its primary lender (the "Bank") at an increased interest rate of prime plus 4.5% (previously prime plus 0.5%) per annum calculated daily and payable monthly. The renewal is in the form of a Forbearance Agreement (the "Agreement") in effect from May 1, 2009 to October 15, 2009 (the "Forbearance Period").

Pursuant to the Agreement, the Company covenants and agrees that it shall:

a) Pay principal and interest on the outstanding loan balance by way of a monthly payment of $175,000 commencing on June 8, 2009;

b) Accept the Bank's retainer of a consultant to monitor the Company's operations as mandated by the Bank with the costs of the consultant paid for by the Company;

c) Obtain prior written consent from the Bank for all capital expenditures;

d) Maintain a specified level of production;

e) Engage a sales agent and prepare the required information for a sales process to commence no later than September 1, 2009 with bids to be provided no later than September 30, 2009 for the sale of as many properties as required to bring the loan amount into compliance with the lending value established by the Bank;

f) Complete a drilling program by July 31, 2009 for two specified wells (note 13(c));

g) Enter into an agreement with the President and Chief Executive Officer ("CEO") of the Company for all salary compensation during the Forbearance Period to be made in the form of common shares of the Company (note 9);

h) Enter into an agreement with its subordinated lender for all interest payments on the subordinated debt (the "credit facility") during the Forbearance Period to be made in the form of common shares of the Company (notes 6 and 9); and

i) To remove any liens exercised against the property and assets of the Company by July 31, 2009 (note 16 (a)).

## 5. Bank debt (continued)

The Company and the Bank agreed to set the next renewal date for the loan at October 15, 2009 at which time a $300,000 forbearance fee is payable to the Bank, which may be reduced to $150,000 in the event that by the renewal date the loan balance is within the lending value established by the Bank and no loan defaults exist.

As at June 30, 2009, the revolving operating demand loan was available to maximum of $8,825,000 (December 31, 2008 – $9,000,000). As at June 30, 2009, the $8,792,417 (December 31, 2008 – $8,853,990) reported amount of bank debt was comprised of $8,675,000 (December 31, 2008 – $8,150,000) drawn on the revolving operating demand loan and $117,417 (December 31, 2008 – $703,990) of bank overdraft.

The Company is subject to a financial covenant with respect to working capital, which the Company was in compliance with at June 30, 2009.

## 6. Credit facility

| | *June 30 2009* | *December 31 2008* |
|---|---|---|
| Principal amount of credit facility | $ 4,500,000 | $ 4,500,000 |
| Unamortized portion of transaction costs | (52,165) | (105,000) |
| | 4,447,835 | 4,395,000 |
| Commitment fee for 2009 facility | – | 90,000 |
| 4% deferred fee due on maturity of 2008 facility | – | 180,000 |
| | $ 4,447,835 | $ 4,665,000 |

As at June 30, 2009 and December 31, 2008, the Company had a $4,500,000 credit facility bearing interest at 12% per annum calculated and payable monthly and maturing on December 31, 2009.

On June 29, 2009, the terms of the credit facility were amended to allow the Company to pay interest calculated and accrued for the period May 1, 2009 to October 15, 2009 in common shares of the Company as required by the Company's primary lender (note 5). The Company's common shares are to be priced on the ten-day weighted average trading price up to and including the last day of every month (the "common share price") in which this payment option is available. The number of common shares to be issued to the lender shall be calculated based on the interest due at month end divided by the common share price. In the event that the common share price is less than $0.05 per common share, the number of common shares to be issued shall remain as calculated, however, the deemed issue price will be $0.05 per share. Pursuant to TSX Venture Exchange rules, the Company may not issue shares at less than $0.05 per share.

Included in the reported amount of long-term payable (note 9) is interest expense for May and June 2009 in the amount of $101,487 based on 2,029,730 common shares at a deemed price of $0.05 per share. The number of shares to be issued was determined based on $90,247 of calculated interest at 12% divided by the common share price at the end of each month (May 2009 – $0.049; June 2009 – $0.040).

Pursuant to the amended terms of the credit facility, financial covenants for working capital, debt to equity and debt to trailing cash flow commence on September 30, 2009.

## 7. 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:

| | |
|---|---|
| Asset retirement obligation, December 31, 2008 | $ 2,124,242 |
| Accretion | 72,410 |
| Liabilities settled | (27,879) |
| Effect of change in estimates | 8,097 |
| Asset retirement obligation, June 30, 2009 | $ 2,176,870 |

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

| | |
|---|---|
| Undiscounted cash flows | $ 4,418,748 |
| Discount rate | 7% - 12% |
| Inflation rate | 2% |
| Weighted average expected timing of cash flows | 11 years |

## 8. Future 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:

| | *Three months ended June 30* | | *Six months ended June 30* | |
|---|---|---|---|---|
| | 2009 | *2008* | *2009* | *2008* |
| Expected income tax reduction at 29.00% (2008 – 29.50%) | $ (265,490) | $ (317,679) | $ (430,018) | $ (626,035) |
| Non-deductible items | 7,492 | 306,669 | 7,957 | 525,382 |
| Rate adjustment and other | 49,194 | (33,089) | 50,969 | (11,372) |
| Change in valuation allowance | 51,112 | 44,099 | 51,112 | 112,025 |
| | $ (157,692) | $ – | $ (319,980) | $ – |

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

| | *June 30 2009* | *December 31 2008* |
|---|---|---|
| Asset retirement obligation | $ 544,218 | $ 531,061 |
| Non-capital and capital loss carryforwards | 51,112 | 256,116 |
| Share issue costs | 10,648 | 9,416 |
| Property and equipment | (2,142,031) | (2,553,738) |
| Valuation allowance | (51,112) | – |
| | $ (1,587,165) | $ (1,757,145) |

As at June 30, 2009, the Company has approximately $32.4 million of tax pools available for deduction against future taxable income.

## 9. Long-term payable

As at June 30, 2009, a long-term payable exists related to shares to be issued as payment for salary compensation of the Company's President and CEO and credit facility interest expense as disclosed in note 5 as the shares were issued subsequent to June 30, 2009 (note 16(c)).

| | *Number of shares to be issued* | | *Amount* |
|---|---|---|---|
| President and CEO compensation, May 1 – June 30, 2009 *(note 5)* | 504,000 | $ | 25,200 |
| Credit facility interest, May 1 – June 30, 2009 *(notes 5 and 6)* | 2,029,730 | | 101,487 |
| | 2,533,730 | $ | 126,687 |

The number of shares to be issued to the President and CEO was determined based on the amount of salary compensation payable for the required period divided by $0.05 per share. Pursuant to TSX Venture Exchange rules, the Company may not issue shares at less than $0.05 per share.

## 10. Share capital

### a) Common shares issued

| | *Number of shares* | | *Amount* |
|---|---|---|---|
| Balance, December 31, 2008 | 75,561,912 | $ | 34,116,201 |
| Tax effect of flow-through shares | – | | (150,000) |
| Balance, June 30, 2009 | 75,561,912 | $ | 33,966,201 |

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. The $150,000 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, of which approximately $560,290 remained unspent at June 30, 2009.

### b) Stock options

| | *Number of options* | *Weighted – average exercise price* |
|---|---|---|
| Balance – December 31, 2008 | 6,267,025 | $ 0.31 |
| Forfeited | (100,000) | (0.30) |
| Balance – June 30, 2009 | 6,167,025 | $ 0.31 |

**10. Share capital** (continued)

**b) Stock options** (continued)

The following table summarizes information about stock options outstanding as at June 30, 2009:

| *Range of exercise price* | *Number outstanding* | *Weighted-average remaining contractual life (years)* | *Weighted-average exercise price* | *Number exercisable* |
|---|---|---|---|---|
| $ 0.10 – $ 0.35 | 4,344,000 | 3.35 | $ 0.19 | 4,344,000 |
| $ 0.45 – $ 0.55 | 1,259,025 | 1.08 | 0.51 | 1,259,025 |
| $ 0.65 – $ 0.74 | 502,250 | 0.74 | 0.72 | 502,250 |
| $ 0.82 | 61,750 | 0.36 | 0.82 | 61,750 |
| | 6,167,025 | 2.65 | $ 0.31 | 6,167,025 |

**11. Royalty recoveries**

During the three and six months ended June 30, 2009, the Company recognized a recovery in the amount of nil and $175,636, respectively, of freehold and gross overriding royalties calculated and paid in previous years.

**12. Change in non-cash working capital**

| | *Three months ended June30* | | *Six months ended June 30* | |
|---|---|---|---|---|
| | *2009* | *2008* | *2009* | *2008* |
| Accounts receivable | $ 173,913 | $ (108,053) | $ 402,748 | $ (436,754) |
| Prepaid expenses and deposits | (11,689) | (11,243) | (25,311) | 18,481 |
| Accounts payable and accrued liabilities | 43,391 | 302,279 | (262,158) | (395,435) |
| | $ 205,615 | $ 182,983 | $ 115,279 | $ (813,708) |

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

| | *Three months ended June30* | | *Six months ended June 30* | |
|---|---|---|---|---|
| | *2009* | *2008* | *2009* | *2008* |
| Operating | $ 117,728 | $ (90,571) | $ 99,597 | $ (202,549) |
| Investing | 87,887 | 273,554 | 15,682 | (611,159) |
| | $ 205,615 | $ 182,983 | $ 115,279 | $ (813,708) |

## 13. Related party transactions

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

**a)** During the three and six months ended June 30, 2009 and 2008, 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:

| | *Three months ended June30* | | *Six months ended June 30* | |
|---|---|---|---|---|
| | *2009* | *2008* | *2009* | *2008* |
| Administration and consulting fees | $ 28,976 | $ 33,737 | $ 49,476 | $ 73,121 |
| Production and capital expenditures | $ 27,000 | $ 27,956 | $ 59,643 | $ 44,797 |

**b)** During the three and six months ended June 30, 2009, the Company was charged $4,172 and $5,316 (three and six months ended June 30, 2008 – $7,434) by a law firm in which a former director of the Company is a partner.

**c)** In June 2009, the Company entered into a participation and farmout agreement (the "Farmout Agreement") with Athabaska Energy Ltd. ("Athabaska"). The Farmout Agreement is a related party transaction as a director and principal shareholder of the Company is also an officer, director and principal shareholder of Athabaska. The Farmout Agreement covers seven sections of Company land and will include the drilling of two wells specified in the Agreement with the Company's primary lender (note 5(f)). Pursuant to the terms of the Farmout Agreement, Athabaska will earn one section of the farmout lands for each well drilled. Athabaska will contribute 100% of the cost to drill, complete and tie-in each well to the Company's facilities in order to earn a 60% working interest in each well at payout. The Company will have the option, up to the spud date of each well, to elect to participate for up to a 25% working interest in the well upon notification by Athabaska of the drilling location.

Included in accounts payable and accrued liabilities at June 30, 2009 is $20,380 (December 31, 2008 – $24,076) 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.

## 14. Financial instruments and financial risk management

The Company's financial instruments include accounts receivable, accounts payable and accrued liabilities, bank debt, credit facility, and commodity price risk contracts (note 14(c)(iii)). The carrying values of accounts receivable, bank debt, accounts payable and accrued liabilities, bank debt, and credit facility approximate their fair values due to their relatively short periods to maturity. The commodity price risk contracts have been marked-to-mark at the balance sheet date.

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:

**14. Financial instruments and financial risk management** (continued)

**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 June 30, 2009, the maximum credit exposure is the carrying amount of the accounts receivable and accruals of $1,308,032 (December 31, 2008 – $1,710,780).

As at June 30, 2009, the Company's receivables consisted of $1,106,669 from joint venture partners and other trade receivables and $201,363 of revenue receivable from a petroleum and natural gas marketer. 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 $201,363 of revenue receivable from petroleum and natural gas marketers was received in July and August 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 June 30, 2009, the largest amount owing from one partner is $611,245.

The Company did not provide for any doubtful accounts nor was it required to write-off any receivables during the period ended June 30, 2009. 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 June 30, 2009, the Company considers its receivables to be aged as follows:

| | |
|---|---|
| Not past due | $ 439,841 |
| Past due by less than 90 days | 59,086 |
| Past due by more than 90 days | 809,105 |
| | $ 1,308,032 |

**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.

**14. Financial instruments and financial risk management** (continued)

**b) Liquidity risk** (continued)

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, all of which have expected maturities of less than one year resulting in their current classification on the balance sheet.

**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 three and six months ended June 30, 2009, if interest rates had been 1% lower with all other variables held constant, loss for the period would have been $21,971 and $41,717 (three and six months ended June 30, 2008 – $18,059 and $37,447) lower, 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 June 30, 2009.

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 June 30, 2009.

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.

**14. Financial instruments and financial risk management** (continued)

**c) Market risk** (continued)

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.

Included in petroleum and natural gas revenue for the three and six months ended June 30, 2009 is $304,180 of realized gains on the fulfilled portion of the commodity contracts. The mark-to-market value of the unfulfilled portion of the above contracts at June 30, 2009 is an asset of $135,343 based on a remaining term of July 1, 2009 to December 31, 2010.

The Company also had commodity price risk contracts in place from April 1, 2008 to December 31, 2008. Included in petroleum and natural gas revenue for the three and six months ended June 30, 2008 is $115,929 of realized losses on the fulfilled portion of the commodity contracts.

**15. 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:

| | *June 30 2009* | *December 31 2008* |
|---|---|---|
| Working capital deficiency | $ (13,300,405) | $ (13,599,207) |
| Shareholders' equity | 23,139,171 | 24,452,012 |
| | $ 9,838,766 | $ 10,852,805 |

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.

**15. Capital management** (continued)

As at June 30, 2009, the Company's capital structure is subject to external restrictions during the Forbearance Period as a result of the Agreement with the Company's primary lender described in note 5 and as a result, the Company's approach to capital management has changed to ensure compliance with the Agreement.

The Company has not paid or declared any dividends since the date of incorporation, nor are any contemplated in the foreseeable future.

**16. Subsequent events**

a) In July 2009, the Company removed all liens exercised against the property and assets of the Company.

b) In July 2009, through the Farmout Agreement described in note 13(c), the Company completed the drilling of one well and commenced the drilling of the second well as specified in the Agreement with the Company's primary lender.

c) On August 18, 2009, the Company issued 504,000 common shares to the President and CEO for May and June 2009 salary compensation and 1,745,753 common shares to the Company's subordinated lender for May and June 2009 interest expense in respect of the long-term payable described in note 9. The common shares are subject to a four month hold period.

d) On August 28, 2009, the Company issued 4,680,783 common shares for the settlement of $280,847 of accounts payable. The common shares are subject to a four month hold period.

**17. 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, of which approximately $560,290 remained unspent at June 30, 2009.

b) The Company is 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.

c) A forbearance fee of $300,000 is payable to the Bank on October 15, 2009 which may be reduced to $150,000 in the event that by the renewal date the loan balance is within the lending value established by the Bank and no loan defaults exist.