

YANGARRA RESOURCES LTD.

MANAGEMENT'S DISCUSSION AND ANALYSIS

For the three and six months ended June 30, 2009

Management's discussion and analysis ("MD&A") of the financial condition and the results of operations should be read in conjunction with the unaudited interim consolidated financial statements of Yangarra Resources Ltd. (the "Company") for the three and six months ended June 30, 2009 and the audited consolidated financial statements for the year ended December 31, 2008, together with the accompanying notes. The MD&A has been prepared using information that is current to August 28, 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.

With the rapid decline in the price of commodities, the price of natural gas in particular, Yangarra has elected to reduce capital expenditures until prices improve, while continuing to monitor the commitment to incur \$600,000 of eligible flow-through expenditures by December 31, 2009. 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 50% of its production. This floor will enable Yangarra to continue to generate positive funds flow from operations until the end of 2009.

Yangarra is also pursuing farmout 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.

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In June 2009, the Company entered into a participation and farmout agreement (the "Farmout Agreement") with Athabaska Energy Ltd. ("Athabaska"). 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 and required by the Company's primary lender. 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.

The two wells required by the primary lender were drilled subsequent to quarter-end with the first well wet and abandoned and the second well capable of 750 mcf per day. The second well, in which Yangarra holds a 16.4% working interest before payout and a 50% working interest after payout, is scheduled to be tied-in to Yangarra compression facilities and production is expected to commence in the first week of September.

The unaudited interim consolidated financial statements were 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 June 30, 2009, the Company had a working capital deficiency of \$13,300,405 and an accumulated deficit of \$13,378,427. At the same time, the Company continues to generate positive cash flow from operations. 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 to continue to obtain capital financing from investors sufficient to meet current and future obligations.

The Company's bank debt and credit facility were renewed in June 2009. The Company's renewal of bank debt (revolving operating demand loan) with the Company's primary lender (the "Bank") was 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. Sayer Energy Advisors has been retained to list the assets or a complete a corporate sale of the Company;
- f) Complete a drilling program by July 31, 2009 for two specified wells (refer to the preceding discussion of the Farmout Agreement);
- 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 (completed);
- h) Enter into an agreement with its subordinated lender for all interest payments on the

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subordinated debt (credit facility) during the Forbearance Period to be made in the form of common shares of the Company (completed); and

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

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.

The Company has also 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. On August 28, 2009, the Company issued 4,680,873 common shares for the settlement of \$280,847 of accounts payable.

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. 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.

Summary Financial Information

	Three months ended June 30		Six months ended June 30	
	2009	2008	2009	2008
Statement of Operations and Deficit				
Net loss for the period	\$ (757,791)	\$ (1,076,877)	\$ (1,162,841)	\$ (2,122,151)
Net loss per share - basic	\$ (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
Statement of Cash Flows				
Funds flow from operations	\$ 180,863	\$ 1,214,745	\$ 613,536	\$ 2,158,849

	June 30 2009	December 31 2008
Balance Sheet		
Property and equipment	\$ 40,330,298	\$ 41,922,138
Total assets	\$ 42,236,907	\$ 44,081,309

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Results of Operations

Net petroleum and natural gas revenue

	Three months ended June 30		Six months ended June 30	
	2009	2008	2009	2008
Net petroleum & natural gas revenue	\$ 533,449	\$ 1,744,759	\$ 1,163,420	\$ 3,172,274
Per boe	\$ 19.17	\$ 39.56	\$ 20.24	\$ 36.81
Net petroleum & natural gas revenue with royalty recovery	\$ 533,449		\$ 1,339,056	
Per boe	\$ 19.17		\$ 23.29	

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

	Three months ended June 30		Six months ended June 30	
	2009	2008	2009	2008
Total boe (boe 6:1)	27,822	44,110	57,484	86,172
Daily sales volumes (boe 6:1)	306	485	318	473
Petroleum & natural gas sales	\$ 909,592	\$ 2,661,004	\$ 1,935,561	\$ 4,765,064
Per boe	\$ 32.69	\$ 60.33	\$ 33.67	\$ 55.30
Royalties	\$ 15,695	\$ 474,228	\$ 79,426	\$ 791,916
Per boe	\$ 0.56	\$ 10.75	\$ 1.38	\$ 9.19
As a % of sales	3%	17%	5%	16%
Royalty recovery	\$ -	\$ -	\$ 175,636	\$ -
Production & transportation costs	\$ 360,448	\$ 442,017	\$ 692,715	\$ 800,874
Per boe	\$ 12.96	\$ 10.02	\$ 12.05	\$ 9.29

- The reduction in production for the 2009 periods as compared to the 2008 periods can be attributed to lower production from Medicine Hat, Ferrier and Viking South wells due to natural declines and the loss of two Bow Island wells in Medicine Hat due to premature watering out. These production declines were partially offset by one new well drilled in the Jaslan area in the latter part of 2008.
- The average price earned by the Company decreased in 2009 due to industry-wide price declines for all commodities as follows:

	Three months ended June 30		Six months ended June 30	
	2009	2008	2009	2008
Oil (\$/bbl)	\$ 63.82	\$ 123.27	\$ 55.80	\$ 113.37
NGL (\$/bbl)	\$ 36.55	\$ 85.12	\$ 38.97	\$ 79.66
Gas (\$/mcf)	\$ 3.24	\$ 10.07	\$ 4.46	\$ 8.81

- 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 commodity contracts from April 1 to June 30,

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2009. Including the realized gains, the average gas price earned by the Company for the three and six months ended June 30, 2009 increases to \$5.20 per mcf and \$5.41 per mcf, respectively.

- 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 commodity contracts. Including the realized losses, the average gas price earned by the Company for the three and six months ended June 30, 2008 decreases to \$9.27 per mcf and \$8.56 per mcf, respectively.
- The decrease in royalties for the 2009 quarter on both a boe and percentage basis relates to lower production and pricing, gas cost allowance adjustments from prior periods in combination with the realized gains from the commodity contracts, on which royalties are not paid. The majority of the Company's properties are at lower royalty rates in 2009 due to lower production levels.
- During the first quarter of 2009, the Company recognized a recovery in the amount of \$175,636 related freehold and gross overriding royalties calculated and paid in previous years.
- Production and transportation costs per boe for the first half of 2009 are higher than those for 2008 due to higher fixed costs per boe attributed to lower 2009 production levels.

Depletion, depreciation and accretion

	Three months ended June 30		Six months ended June 30	
	2009	2008	2009	2008
Depletion and depreciation	\$ 985,474	\$ 1,097,532	\$ 2,030,848	\$ 2,268,262
Per boe	\$ 35.42	\$ 24.88	\$ 35.33	\$ 26.32
Accretion	\$ 36,174	\$ 30,457	\$ 72,410	\$ 60,914

The depletion rate for first half of 2009 is higher as compared to 2008 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 in proved reserves in previously evaluated areas and current year production that has not been replaced by addition of new reserves. Reductions were primarily due to unexpectedly low pool pressure indications in Ferrier and premature watering out of a gas reservoir in Medicine Hat.

Accretion expense increased in 2009 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 June 30		Six months ended June 30	
	2009	2008	2009	2008
General and administrative expenses	\$ 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

General and administrative expenses have decreased due to management's continued efforts to monitor and reduce costs. In addition, \$25,200 of the expenses for the three and six months ended June 30, 2009 will be satisfied by the issuance of shares as opposed to a cash expense.

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Interest and financing fees for the three months ended June 30, 2009 includes:

- \$4,269 of Part XII.6 interest on the unspent portion of flow-through expenditures to be incurred by December 31, 2009;
- \$74,250 on the revolving operating demand loan for which the average amount drawn during the period was \$8,812,500 at an effective interest rate of 3.38% compared to \$117,922 in the 2008 period on an average loan balance of \$7,686,310 at an effective interest rate of 6.30%; and
- \$171,882 of interest and financing fees on the credit facility based on the effective interest method compared to \$188,673 for the 2008 period. 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).

Interest and financing fees for the six months ended June 30, 2009 includes:

- \$6,253 of Part XII.6 interest on the unspent portion of flow-through expenditures to be incurred by December 31, 2009;
- \$164,219 on the revolving operating demand loan for which the average amount drawn during the period was \$8,412,500 at an effective interest rate of 3.82% compared to \$237,967 in the 2008 period on an average loan balance of \$7,510,000 at an effective interest rate of 6.35%; and
- \$331,709 of interest and financing fees on the credit facility based on the effective interest method compared to \$376,339 for the 2008 period.

The Company did not grant any stock options or record any stock-based compensation (“SBC”) during the three and six months ended June 30, 2009.

In the three and six months ended June 30, 2008, a total of \$567,037 and \$809,090, respectively, was recognized for SBC. Of the total, \$182,990 and \$237,454 was attributed to stock options granted to field personnel and capitalized to property and equipment in the three and six month periods. The remaining SBC for the three and six month periods of \$384,047 and \$571,636, respectively, was recorded as expense in the interim consolidated statements of operations.

Commodity price risk contracts

	Three months ended June 30		Six months ended June 30	
	2009	2008	2009	2008
Unrealized (gain) loss on commodity price risk contracts	\$ (34,047)	\$ 688,554	\$ (135,343)	\$ 1,202,356

2009 unrealized gain: 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

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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.

2008 unrealized loss: In February 2008, the Company committed to 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 December 31, 2008 ⁽¹⁾ 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 December 31, 2008 ⁽¹⁾ at a ceiling price of \$8.15 per GJ and a floor price of \$7.50 per GJ.

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. The mark-to-market value of the unfulfilled portion of the contracts at June 30, 2008 was a liability of \$1,202,356 based on the remaining term of July 1, 2008 to December 31, 2008.

⁽¹⁾ In July 2008, the Company amended the third and fourth contracts to terminate on August 31, 2008 for which the Company received a payment of \$3,050.

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.

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 was 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

Future income tax reduction

During the three and six months ended June 30, 2009, the Company recorded a reduction of future income taxes of \$157,692 and \$219,980, respectively, (three and six months ended June 30, 2008 – nil) related to the reversal of temporary differences between the carrying value and tax basis of the Company's property and equipment.

Liquidity and Capital Resources

During the six months ended June 30, 2009, the Company generated \$613,536 of funds flow from operations compared to \$2,158,849 in the 2008 comparative period. The reduction in funds flow from

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operations is primarily due to the effect of lower production and commodity prices on net petroleum and natural gas revenue.

The Company's revolving operating demand loan is subject to an Agreement from May 1 to October 15, 2009 at which time the loan will be subject to review by the Company's primary lender. Commencing June 8, 2009, the Company is required to pay principal and interest on the outstanding loan balance by way of a monthly payment of \$175,000. Other details of the Agreement are provided in the Company Description and Outlook section.

As at June 30, 2009, the revolving operating demand loan was available to maximum of \$8,825,000 (December 31, 2008 – \$9,000,000), of which \$8,675,000 was drawn. The Company is subject to a working capital covenant for the revolving operating demand loan which was met at June 30, 2009.

On June 29, 2009, the terms of the \$4,500,000 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 Agreement between the Company and its primary lender. 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.

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.

As at June 30, 2009, the Company had a working capital deficit of \$13,300,405 compared to \$13,599,207 at December 31, 2008. The improvement in the working capital deficit was due to \$613,536 of funds flow generated by operating activities, \$33,669 of proceeds on the sale of the Company's minority equity position in a public company and an asset of \$135,343 for the fair value of the commodity price risk contracts offset by \$430,911 of capital spending and \$52,835 related to the amortized cost of the credit facility.

Capital Spending

Capital spending is summarized as follows:

	Three months ended June 30		Six months ended June 30	
	2009	2008	2009	2008
Land and lease rentals	\$ 43,181	\$ 154,345	\$ 90,610	\$ 441,787
Drilling and completion	118,800	1,120,306	284,914	1,620,005
Geological and geophysical	6,861	5,721	30,745	29,842
Equipment	(35,944)	232,728	24,642	488,731
	132,898	1,513,100	430,911	2,580,365
Dispositions	-	-	-	(50,000)
	\$ 132,898	\$ 1,513,100	\$ 430,911	\$ 2,530,365

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Asset Retirement Obligation

As at June 30, 2009, the undiscounted fair value of the asset retirement obligation associated with the Company's existing properties was estimated to be \$4,418,748 for which \$2,176,870 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 years.

Related Party Transactions

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

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.

In June 2009, the Company entered into a participation and Farmout Agreement with Athabaska as discussed under the Company Description and Outlook section. 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.

Subsequent Events

- In July 2009, the Company removed all liens exercised against the property and assets of the Company.
- In July 2009, through the Farmout Agreement with Athabaska Energy Ltd., 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.
- On August 18, 2009, the Company issued 504,000 common shares to the President and CEO for salary compensation for May and June 2009, and 1,745,753 common shares to the Company's subordinated lender pursuant to the Agreement with the Company's primary lender. The common shares are subject to a four month hold period.
- 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.

Share Capital

Common shares

As at December 31, 2008 and June 30, 2009 there were 75,561,912 issued and outstanding common shares.

In August 2009, the Company issued 6,930,536 common shares increasing the number of shares outstanding as at the date of this MD&A to 82,492,448.

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Stock options

As at December 31, 2008, the Company had 6,267,025 stock options outstanding all of which are exercisable. During the six months ended June 30, 2009, 100,000 options were forfeited. As at June 30, 2009 and the date of this MD&A, the Company had 6,167,025 stock options outstanding.

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 June 30, 2009 or December 31, 2008.

Commitments

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.

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.

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.

Financial Instruments

The Company's financial instruments include accounts receivable, accounts payable and accrued liabilities, bank debt, credit facility, and commodity price risk contracts. 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.

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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 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
		<hr/>
	\$	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.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. The Company uses authorizations for expenditures on both

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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.

Commodity price risk contracts for the sale of natural gas in place at June 30, 2009 are detailed in the Commitments section. The mark-to-market value of the unfulfilled portion of the commodity price risk contracts at June 30, 2009 is an asset of \$135,343 based on a remaining term of July 1, 2009 to December 31, 2010.

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.

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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
	<u>\$ 9,838,766</u>	<u>\$ 10,852,805</u>

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.

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 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.

Selected Historical Financial Information

2009	First Quarter	Second Quarter
Petroleum and natural gas sales	\$ 1,025,969	\$ 909,592
Net petroleum and natural gas revenue	\$ 805,607	\$ 533,449
Net loss	\$ (405,050)	\$ (757,791)
Net loss per share	\$ (0.01)	\$ (0.01)
Funds flow from operations	\$ 432,673	\$ 180,863
Net capital expenditures	\$ 298,013	\$ 132,898

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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

2007	First Quarter	Second Quarter
Petroleum and natural gas sales	2,606,074	2,256,132
Net petroleum and natural gas revenue	1,889,356	1,796,580
Net income (loss)	(868,562)	(32,886)
Net income (loss) per share	(0.02)	–
Funds flow from operations	1,281,607	1,138,801
Net capital expenditures (proceeds)	1,378,362	430,456

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 14 to the June 30, 2009 unaudited interim 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

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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, 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.

Changes 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.

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

	Effective for Annual Periods Beginning on or After
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.