

# **Canadian Spirit Resources Inc.**

## **MANAGEMENT DISCUSSION AND ANALYSIS**

**For the year ended December 31, 2008**

This management discussion and analysis (“MD&A”) of the financial conditions and results of operations should be read in conjunction with the audited financial statements for the year ended December 31, 2008 (all amounts in Canadian dollars).

### **Date**

This MD&A includes information up to April 23, 2009.

### **Reader’s Advisory**

Information provided herein contains estimates and assumptions which management is required to make regarding future events and may constitute forward-looking statements within the meaning of applicable securities laws. Management’s assessment of future plans and operations, capital expenditures, methods of financing capital expenditures and the ability to fund financial liabilities, expected commodity prices and the impact on Canadian Spirit Resources Inc. (“CSRI” or the “Company”), expected increase in royalty rates, and the timing of and impact of adoption of International Financial Reporting Standards and other accounting policies may constitute forward-looking statements under applicable securities laws and necessarily involve risks including, without limitation, risks associated with natural gas exploration, development, exploitation, production, marketing and transportation, loss of markets, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risk, competition from other producers, inability to retain drilling rigs and other services, incorrect assessment of the value of acquisitions, failure to realize the anticipated benefits of acquisitions, the inability to fully realize the benefits of the acquisitions, delays resulting from or inability to obtain required regulatory approvals and ability to access sufficient capital from internal and external sources.

Although management believes the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will be realized. The use of any of the words “anticipate”, “believe”, “continue”, “estimate”, “expect”, “forecast”, “may”, “intend”, “likely”, “will”, “project”, “plan”, “should”, “possible”, “probable”, “schedule”, “position”, “goal”, “objective”, and similar expressions are intended to identify forward-looking information. These statements are subject to certain risks and uncertainties and may be based on assumptions that could cause actual results to differ materially from those anticipated or implied in the forward-looking statements. The risks associated with these forward-looking statements include, but are not limited to, the following:

- Fluctuations in natural gas production levels
- CSRI’s ability to raise funds in the current volatile and uncertain equity market conditions
- Volatility in market prices for natural gas
- Changes in foreign currency exchange and interest rates

The Company will endeavor to update all forward-looking statements for any material changes to the circumstances or information and estimates presented herein as feasible or as required by applicable securities laws.

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### **Corporate Overview**

Canadian Spirit Resources Inc. is a natural resources company listed on the TSX Venture Exchange focusing on the identification and development of opportunities in the unconventional gas sector of the energy industry.

Since May 2002, the Company's focus has been to evaluate the resource potential of certain unconventional natural gas exploration properties and is considered to be in its development stage of operations. Although some preliminary evaluation work was performed on coalbed methane prospects prior to May 2002, the decision to change the strategic direction of the Company from the evaluation of the Isk Wollastonite Mineral Property to an evaluation of unconventional natural gas prospects occurred at this time. In the fall of 2003, CSRI drilled its first well and acquired a small land position in the Farrell Creek area of British Columbia. In the years following, the Company acquired a significant land position in this same area, drilled eight additional wells and was evaluating the productive capability of the Gething Formation through year-end 2007. In 2008, the Company entered into joint venture agreements with Shell Canada Energy ("Shell" or the "Operator") and Canbriam Energy Inc. ("Canbriam") to explore and further advance the development of its major resource property at Farrell Creek. The joint venture with Canbriam will result in the exploration and evaluation of petroleum and natural gas rights (primarily in the Montney Formation) below the base of the Cadomin/Nikanassin Formation ("Deep Rights") and the second joint venture with Shell will advance the development of rights (primarily the Gething Formation) from surface to the base of the Cadomin/Nikanassin Formation ("Shallow Rights").

On February 14, 2008, the Company announced that Mr. Donald Gardner was appointed as Chief Executive Officer. Mr. Gardner, previously a consultant to the Company, entered into a permanent employment contract with the Company effective January 1, 2009.

On January 6, 2009, the Company announced that Mr. Dean Hill, Vice President, Finance was also appointed as Chief Financial Officer effective December 18, 2008.

2008 was a very important year for the Company strategically. Early in the year, despite the Company facing lower working capital levels, low natural gas prices and difficult equity market conditions, a \$5.6 million private placement was successfully completed in February. By the middle of the year, petroleum commodity prices had rebounded and the Company strengthened its working capital position further by closing a \$3.1 million private placement in July as well as accepting the exercise of \$1.6 million of previously issued share purchase warrants. During this period, the Company also entered into the Deep Rights and Shallow Rights joint ventures, the latter providing for a \$5.0 million reimbursement to the Company to recognize prior capital expenditures. All these transactions were important for the Company to strategically position itself with a strong working capital position and no debt. In the face of changing economic conditions, lower petroleum commodity prices and tightening equity market conditions in the latter part of 2008 and into 2009, the Company is now well-positioned to withstand these conditions and move towards its strategic initiatives. While access to additional capital remains tight, the Company's strong working capital position (currently \$11.0 million as of the date of this report), no debt, and the structuring of the two joint ventures such that the Company has minimal capital requirements until at least 2010 will ensure that the Company moves forward with its goals and objectives and thus continues to enhance shareholder value.

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### Results of Operations

#### *Farrell Creek, British Columbia:*

The focus of the Company's activities is currently on the evaluation and development of its principal resource property in the Farrell Creek area of northeast British Columbia, located approximately 70 kilometers west of Fort St. John. In a report dated April 6, 2009, Sproule Unconventional Limited estimated total natural gas resources (both discovered and undiscovered) to be approximately 1.7 trillion cubic feet in the Gething, Moosebar and Gates Formations on the Company's lands at Farrell Creek. Through joint ventures with Canbriam and Shell, the Company is continuing to evaluate and develop the Deep Rights and the Shallow Rights on its Farrell Creek properties. With our joint venture partners currently bearing the exploration costs on these lands, the Company is able to look at new opportunities without immediate need to access our own capital or the equity markets. See **Business Risks** on Page 12 of this MD&A.

#### *Farrell Creek: Montney*

On March 19, 2008, the Company announced a joint venture and farmout agreement for the Deep Rights with Canbriam, a private energy company based in Calgary, Alberta, that will evaluate certain of the Company's lands for Montney and other deep formation plays covering over 29,000 gross acres. Canbriam will earn a 65% working interest in the Deep Rights by drilling and evaluating two commitment wells to at least the Montney Formation, with the Company retaining a 35% working interest. The joint venture agreement with Canbriam also provides for CSRI to receive a credit for its share of future capital expenditures, which could result in CSRI having no capital obligations through the initial \$29 million of gross expenditures within the joint venture, even including earning wells brought to production. Canbriam has an option to increase its working interest to 70% by increasing the Company's credit amount.

Pursuant to its agreement with the Company, Canbriam has drilled two wells targeting the Montney Formation on the eastern portion of the Farrell Creek lands. As a result of Canbriam drilling these wells, CSRI holds rights from surface to base of the Belloy Formation in seven sections, allowing the joint venture partners to undertake further work on these lands.

Geological and technical data obtained during the evaluation of the Upper Montney Formation in the two wells resulted in a decision not to proceed with a horizontal section at this time. Further evaluation of the Upper Montney Formation on this block of seven sections and the additional thirteen sections subsequently acquired may be undertaken in the future with the development of infrastructure, technological improvements or higher natural gas prices.

During the drilling of these two wells, other potentially economic gas zones were identified and are expected to be further evaluated. The timing of this evaluation will depend largely on the development of pipeline infrastructure in proximity to these lands. One of the wells has been granted "New Pool Discovery" status.

Canbriam has indicated that it plans to conduct further operations beginning with one horizontal well targeting the Montney Formation on the western portion of the Farrell Creek lands during the third quarter of 2009.

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Land prices for Montney Formation rights in the Farrell Creek area remain strong and drilling by various operators continues to be active. On November 12, 2008, bids ranging from \$5,413 to \$14,878 per hectare for drilling licences in the Farrell Creek area resulted in a total bid of \$105.6 million. The parcels attracting the higher bids are in close proximity to the western portion of the Company's Farrell Creek lands.

At the November 12, 2008 B.C. land sale and again at the March 25, 2009 sale, CSRI continued to add to its land position in this prospective area of northeastern British Columbia. On behalf of the joint venture, CSRI acquired additional rights from surface to base Montney Formation in thirteen sections adjoining the eastern portion of the Farrell Creek lands.

In a December 10, 2008 presentation to the Hudson's Hope Town Council, Talisman Energy Inc. ("Talisman") generated further confidence in the future of the Farrell Creek area by outlining a potential for \$7.5 billion in capital projects across 60 sections over a ten year period if their current pilot project proves successful.

### ***Farrell Creek: Gething***

On July 17, 2008 the Company announced that it had entered into a joint venture with Shell to advance the development of the identified unconventional natural gas resource in the Gething Formation on a combined total of approximately 145 contiguous sections or 92,800 acres located in the Farrell Creek area. Following an initial expenditure of approximately \$50 million, Shell may elect to proceed into the development phase resulting in the pooling of each respective party's Shallow Rights. The pooling of these Shallow Rights will result in the joint venture partner holding a 75% working interest in the Farrell Creek project and the Company retaining a 25% interest across approximately 145 sections. Proceeding to the development phase would commit Shell to additional capital spending or a payment to the Company. In effect, the Company would retain significant holdings across a larger project area with our joint venture partner leveraging our ability to evaluate and develop the Gething Formation.

The first phase of the expansion program began with Shell's purchase of approximately 95 sections of Shallow Rights in the Farrell Creek area and is advancing with the drilling of 4 vertical Gething wells and one deep water disposal well, and the construction of facilities to connect the pilot project to the Spectra Energy pipeline. Shell became the Operator of these properties in September 2008.

During October two vertical Gething wells were drilled on the east side of the Farrell Creek property followed by two more vertical wells drilled into the Gething Formation in the pilot project area located on the western portion of the property.

In the second quarter of 2009, the joint venture expects to connect the pilot project into the Spectra Energy pipeline and commence gas sales. Construction and commissioning of the plant, gathering system and pipeline connecting the pilot project wells to the Spectra Energy pipeline will enable the Operator to continuously produce these and future Gething wells without the need to flare methane into the atmosphere. The objective of continuous production is to optimize the completion and production technologies that will be applied when the Farrell Creek Gething project moves to the development phase.

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**For the year ended December 31, 2008**

### ***General:***

CSRI expects to be one of the first companies to bring a major unconventional gas resource (natural gas from coal) into production in British Columbia. The Farrell Creek area of northeastern British Columbia is generating a significant level of activity from companies targeting unconventional gas prospects with substantial land prices being received by the Government of British Columbia. On November 12, 2008 Montney Formation lands in close proximity to the Company's Farrell Creek project attracted prices of over \$3.8 million per section or \$14,878 per hectare.

Talisman has also provided what we believe to be significant test results and spending plans for the Farrell Creek area. In December 2008, Talisman reported results from the c-85-I vertical well with an initial flow of 5 million cubic feet per day (mmcf/d) from the Montney Formation, approximately 2 miles from CSRI's Montney lands. As part of Talisman's potential \$7.5 billion in capital projects for the area, 2009 would include at least 7 horizontal wells and a sweet gas plant with initial capacity of up to 20 mmcf/d that could be on stream by November 1, 2009 with the potential for expansion.

In order to accelerate and expand the evaluation and development of the Farrell Creek properties, the Company has leveraged its financial resources through two joint venture arrangements with well capitalized partners while retaining a substantial interest in each project. Success in the Farrell Creek properties will ultimately result in additional investment from the Company and its partners.

### ***Bittern Lake, Alberta:***

In 2005 and 2006 the Company drilled four and completed two Horseshoe Canyon wells on these 50% joint venture lands. After initial positive indications formation water production increased and the wells were shut in. Effective May 1, 2008 the Company sold its interests in these four wells, including associated abandonment and reclamation liabilities, for a consideration of \$22,500 and a 5% overriding royalty. The Company has retained a 50% interest in the rights to the Mannville Formation on three sections, however CSRI's efforts in 2009 will be focused on the Farrell Creek, B.C. properties.

### ***Isk Wollastonite Mineral Property, British Columbia:***

No field work has been conducted at the Isk Wollastonite mine site during 2007-2009. This asset is available for farm-out or sale.

As of the date of this report, the Company has a strong working capital position of approximately \$11.0 million composed primarily of cash and receivables from its joint venture partners. The Company currently has minimal immediate capital commitments within the scope of its two joint ventures requiring additional cash investment.

In recent months, the global financial environment has had an adverse affect on capital markets and commodity prices. This has impacted the ability of many companies to raise equity capital and may represent an increased number of opportunities for well capitalized companies. CSRI may investigate some of these opportunities.

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### *Reserves:*

The Company has neither any discovered contingent or recoverable resource nor reserves from natural gas interests at December 31, 2008. The Company's Statement of Reserves Data and Other Oil and Gas Information is incorporated in the Company's Annual Information Form dated April 23, 2009.

### **Selected Annual Information**

For the years ended or as at December 31	2008	2007
Total revenues	\$ 133,344	\$ 90,522
Net loss and comprehensive loss (after income taxes)	\$ (1,698,232)	\$ (875,564)
Loss and comprehensive loss per share (basic & diluted)	\$ (0.04)	\$ (0.03)
Total current assets	\$ 12,850,473	\$ 1,205,479
Total assets	\$ 47,535,538	\$ 38,748,627
Total current liabilities	\$ 1,132,785	\$ 872,444
Total long term liabilities	\$ 211,848	\$ 198,685
Net working capital	\$ 11,717,688	\$ 333,035
Net capital (recoveries) expenditures	\$ (2,837,064)	\$ 4,766,992

### **Significant items affecting results over the past two years**

During the two year period ended December 31, 2008, the Company had no operating revenue and is considered to be in its development stage of operations. Reported revenue during the two years is interest on cash deposits. The greater amount of reported revenue in 2008 was the result of significantly higher average cash balances during the year, despite a lower average effective interest rate than in 2007.

The fair value of stock options is measured at the grant date and charged to earnings over the vesting period with a corresponding increase in contributed surplus. The number of stock options issued in a period, the vesting provisions of such options and the historic volatility of the Company's share price influence the amount of stock-based compensation expense in current and future periods. The compensation amount for stock options charged against earnings in 2008 was \$375,595 (2007: \$318,710).

In 2003, the Company granted share appreciation rights ("SARs") entitling the holders to cash payments equal to the excess of the then current price of the common shares (to a maximum of \$3.65) over the exercise price of the right. The provision for the potential liability associated with SARs was calculated quarterly over the three year vesting period of these rights based on the closing price of the Company's shares at the end of each period. The compensation cost was charged to stock-based compensation expense on a straight-line basis over the vesting period with a corresponding increase in accrued liabilities, but subsequently has been adjusted upward or downward based on movement of the price of the Company's shares until the fourth quarter of 2008. The holder's right to exercise vested SARs is conditional upon the Company achieving certain production or profit thresholds. The Board of Directors determined that the exercise conditions associated with these SARs had been achieved and extended the expiry date of the SARs from August 28, 2008 to January 28, 2009. On October 30, 2008 the Board of Directors approved a grant of 600,000 stock options, at an exercise price of \$0.50 per share with a term of

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five months (having an expiry date of March 31, 2009) to replace all the existing outstanding SARs. The difference of \$0.02 between the exercise price of the SARs and the replacement stock options was paid out to the SARs holders in cash in the fourth quarter 2008. The final total compensation recovery for SARs for 2008 was therefore only \$18,000 compared to a recovery of \$516,000 in 2007.

### **Revenue**

Revenues during the year ended December 31, 2008 of \$134,758 (2007: \$91,634) represent interest on cash deposits. The Company anticipates natural gas revenues from its Farrell Creek joint venture commencing in the second quarter of 2009.

### **General and Administration Expenses**

For the years ended December 31	2008	2007
Consulting fees	\$ 399,294	\$ 470,540
Salaries and benefits	1,270,532	775,907
Other general and administrative	639,340	519,738
	<u>2,309,166</u>	<u>1,766,185</u>
Less: capitalized and other costs	<u>(694,826)</u>	<u>(660,674)</u>
	<u>1,614,340</u>	<u>1,105,511</u>
Stock-based compensation	<u>357,595</u>	<u>(197,290)</u>
	<u>\$ 1,971,935</u>	<u>\$ 908,221</u>

In the fourth quarter of 2007, the Company terminated the consulting arrangements with two professional engineers, but in 2008 continued the consulting contracts with a director and executive officer of the Company, a financial advisor, a land consultant, and a computer network maintenance company. During the course of 2008, the Company entered into additional consulting agreements with a second financial advisor and a business development specialist. In 2009, up to the date of this report, the Company has since discontinued the consulting agreements with the first financial advisor, the director and executive officer of the Company and the business development specialist.

Consulting fees, after capitalization, have remained relatively constant for the year ended December 31, 2008 compared with 2007 (\$192,098 and \$186,664 respectively).

Salaries and benefits, after capitalization, have increased for the year ended December 31, 2008 compared with 2007 (\$823,283 and \$427,344 respectively) due to employee bonuses of \$180,000 declared and paid in the third and fourth quarters of 2008, as well as severance payments of \$204,212 associated with a former executive officer of the Company and the hiring of an investor and community relations manager during the fourth quarter 2008. The Company capitalizes salaries and benefits associated with staff directly related to exploration and development activities.

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### For the year ended December 31, 2008

During the twelve months ended December 31, 2008, the Company capitalized a total of \$676,753 (2007: \$644,675) of general and administration expenses directly related to exploration and development activities, which are therefore included as part of the property, plant and equipment costs recorded by the Company. The other costs capitalized in the twelve months ended December 31, 2008 of \$18,073 (2007: \$15,999) relate to consulting fees incurred in relation to equity instruments issue costs, and are therefore recorded by the Company as a reduction of shareholders' equity.

Due to the levels of stock options granted, as well as an increase in the market price of the Company's shares, but offset by the exchange of all outstanding SARs for stock options as approved by the Board of Directors, stock-based compensation resulted in a net expense in 2008 compared with a net recovery in the same period for 2007. See **Summary of Quarterly Results** on Page 9 for further analysis of the effect on stock-based compensation on the overall results of the Company. The closing price of \$0.62 per share on the TSX Venture Exchange on December 31, 2008 represents a 22% increase from the closing price of \$0.51 per share at December 31, 2007.

#### Other General and Administration Costs

For the years ended December 31	2008	2007
Professional fees	\$ 59,038	\$ 90,071
Investor relations & filing fees	91,965	96,466
Office premises & insurance	334,660	214,095
Office supplies	89,695	65,446
Staffing costs	51,291	49,720
Other	12,691	3,940
	<u>639,340</u>	<u>519,738</u>
Less: capitalized costs	<u>(40,381)</u>	<u>(28,235)</u>
	<u>\$ 598,959</u>	<u>\$ 491,503</u>

Professional fees have declined by 34% during 2008 compared to 2007 due to a decrease in legal fees, related purely to the number of corporate matters requiring advice or assistance from the Company's legal counsel, and due to a reduction in the year-end accrual for engineering reserve report fees for 2008 over 2007.

Office premises costs were 56% higher during 2008 compared to 2007 due to higher net rents as well as increases in insurance and office operating costs. Office related expenses are anticipated to continue at current levels pursuant to the terms of the Company's existing sub-lease agreement.

The increase in office supplies expense of 37% for the year ended December 31, 2008 compared to 2007 is due primarily to additional engineering and economic model software rental costs.

Other expense is comprised of advertising and promotion costs, charitable contributions and bank charges.

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### Summary of Quarterly Results

Net results prior to income taxes from the beginning of 2006 were:

Income (loss) by quarter	2008		2007		2006	
	Amount	Per Share (basic & diluted)	Amount	Per Share (basic & diluted)	Amount	Per Share (basic & diluted)
First Quarter	\$ (498,821)	\$ (0.01)	\$ (279,955)	\$ (0.01)	\$ (975,817)	\$ (0.04)
Second Quarter	(824,651)	(0.02)	(150,227)	-	31,536	-
Third Quarter	(35,726)	-	(42,936)	-	174,092	0.01
Fourth Quarter	(513,575)	(0.01)	(402,446)	(0.02)	(305,026)	(0.01)
Loss before income taxes	<u>\$ (1,872,773)</u>	<u>\$ (0.04)</u>	<u>\$ (875,564)</u>	<u>\$ (0.03)</u>	<u>\$ (1,075,215)</u>	<u>\$ (0.04)</u>

For each period up to and including December 31, 2008, the existence of stock options and warrants affected the calculation of diluted shares outstanding. As the effect of this dilution is to reduce the reported loss per share, diluted loss per share information has not been shown.

In 2007 and 2008, the Company financed a portion of its development activities through the issue of Flow-Through Shares. Under the terms of these share issues, the related resource expenditure deductions for income tax purposes are renounced to investors in the year of issue. When the expenditures are renounced, share capital is reduced and future income tax recoveries are calculated at the estimated value of the renounced tax deductions. The Flow-Through Share issues that occurred in 2007 resulted in a calculated potential recovery of future income taxes of \$172,925. This recovery was not reflected within the valuation allowance of the Company until the first quarter of 2008 however as that is when the actual renouncement documents were filed with the government authorities. See **Share Capital** on Page 16 for a description of the Flow-Through Share issue concluded in July 2008.

As discussed previously, stock-based compensation expense for stock option grants and SARs has contributed significantly to the variability of the Company's income and losses since the beginning of 2006. Related to the SARs issued to two executive officers and a senior employee in August 2003, changes in the value of the Company's shares have an immediate impact on the quarterly provision for this potential liability. In the fourth quarter 2008, the Board of Directors of the Company approved a grant of 600,000 stock options to replace all 600,000 existing SARs. As a result, the liability related to the SARs was discharged as of the year-end and a recovery of the remaining SARs stock-based compensation liability was recognized in the fourth quarter 2008. Excluding the effects of stock-based compensation, the Company's pre-tax losses by quarter would have been:

### Loss by quarter prior to stock-based compensation expense

	2008	2007	2006
First Quarter	\$ (252,197)	\$ (299,988)	\$ (216,771)
Second Quarter	(331,029)	(235,382)	(277,597)
Third Quarter	(313,547)	(236,982)	(257,468)
Fourth Quarter	(618,405)	(300,502)	(318,597)
Loss before income taxes	<u>\$ (1,515,178)</u>	<u>\$ (1,072,854)</u>	<u>\$ (1,070,433)</u>

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The larger loss prior to stock-based compensation expense in the fourth quarter 2008 is due to the payment of severance costs of \$204,212 to a former executive officer of the Company.

### Fourth Quarter Results

Fourth quarter results for each of the past two years are as follows:

<b>For the three months ended December 31</b>	<b>2008</b>	<b>2007</b>
<b>Revenue</b>		
Interest and other income	<u>\$ 34,163</u>	<u>\$ 19,410</u>
<b>Expenses</b>		
Consulting fees	50,914	38,955
Salaries and benefits	398,905	128,923
Other general administration	194,938	156,620
Stock-based compensation	(104,830)	101,944
Accretion expense	1,669	(16,144)
Impairment of completion costs	-	-
Amortization	6,142	11,558
	<u>547,738</u>	<u>421,856</u>
<b>Loss before income taxes</b>	<u>\$ (513,575)</u>	<u>\$ (402,446)</u>

During the fourth quarter of 2008 the Company earned \$34,013 (2007: \$19,859) in interest revenue from cash deposits.

Salaries and benefits experienced a large increase in the fourth quarter 2008 due to severance costs related to a former executive officer leaving the Company. Total severance costs of \$204,212 were paid to the former executive officer of the Company upon termination. The remainder of the increase compared to the further quarter 2007 relates to regular year-over-year increased rates for salaries and benefits, as well as the hiring of an investor and community relations manager during the fourth quarter 2008.

Other general and administration expenses in the fourth quarter of 2008 were 24% higher than the comparative 2007 period due to an increase in net rent in 2008 pursuant to the terms of the Company's existing sublease agreement, as well as incremental costs relating to the relocation of two of the Company's employees during the quarter.

Stock-based compensation is composed of expenses related to the contingent SARs liability and amortization of the calculated fair value of stock options granted in current and prior periods. In the fourth quarter of 2008, the SARs and stock option components of stock-based compensation resulted in a recovery of \$246,000 and expense of \$141,170 respectively (2007: recovery of \$228,000 and expense of \$329,944 respectively). Volatility in stock-based compensation expense from period to period is, in the case of SARs, related to share price movements and, in the case of stock options, related to the issuance of new options or the cancellation or modification of previously issued options.

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Capital expenditures during the fourth quarter of 2008 were \$0.3 million compared to \$1.4 million in the same period of 2007. Field activities in the last quarter of 2008 were conducted via the Company's joint venture partners with limited capital commitments required to be outlaid by CSRI.

#### **Liquidity and Capital Resources**

The Company's capital program for the past two years is detailed in the following table:

For the years ended December 31	2008	2007
Lease acquisitions and retentions	\$ 68,133	\$ 84,453
Geological and geophysical	50,418	20,146
Net (recovery of) drilling and completion costs	(3,693,002)	4,014,467
Capitalized overhead	676,753	644,675
Total net petroleum and natural gas	(2,897,698)	4,763,741
Computer and office equipment, furniture	60,634	3,251
Total net capital (recoveries) expenditures	\$ (2,837,064)	\$ 4,766,992

For the year 2008, the Company had a base case capital budget of \$4.3 million including the Company's portion of the joint venture tie-in of the Farrell Creek pilot program to the Spectra Energy sales pipeline, and including an estimated \$560,000 for capitalized overhead. In addition, the Company provided for an allocation for drilling and field testing activities of \$1.9 million in 2008. The Company's budget is reviewed and approved by the Board of Directors on a quarterly basis. To December 31, 2008, net capital expenditures after recoveries totaled \$2.2 million (gross - \$5.8 million before recoveries for joint venture partners).

Offsetting the Company's 2008 capital expenditures was the additional reimbursement in the second half of 2008 of \$5.0 million of previously expended drilling and completion costs from a joint venture partner in relation to the Farrell Creek pilot program costs prior to 2008. The recovery of these expenditures has been recorded as a reduction of capitalized drilling and completion costs for the year ended December 31, 2008.

For the first quarter of 2009, the Company has a base case capital budget of \$1.2 million, including the Company's portion of the facilities and tie-in work per the Shallow Rights joint venture at the Company's Farrell Creek pilot program site, and including an estimated \$134,000 for capitalized overhead. The first quarter 2009 budget was approved by the Company's Board of Directors. After recoveries from the joint venture partners, the Company's net capital expenditures for the first quarter 2009 are projected to be approximately \$0.2 million.

Cash administration expenses (G&A excluding stock based compensation) for 2009 are expected to total approximately \$1.8 million before capitalization of exploration and development related overhead, approximately the same as the 2008 budgeted amount. Revenue from interest on cash balances is budgeted at \$204,000 for the 2009 year. The Company has budgeted for minimal cash flows from operations during 2009 resulting from the expected tie-in of the Farrell Creek pilot program commencing the second quarter of 2009.

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At December 31, 2008, the Company had working capital of \$11.7 million, consisting of cash in the amount of \$11.2 million, accounts receivable and prepaid expenses of \$1.6 million, and net of accounts payable and accrued trade liabilities of \$1.1 million. The accounts payable and accrued trade liabilities relate to the pilot program tie-in at Farrell Creek that was continuing during the fourth quarter of 2008. The Company has no bank indebtedness and has no credit agreements to borrow money in place at this time.

The Company's working capital of \$11.7 million at December 31, 2008 is considered by management to be more than sufficient to cover its administrative costs and its base case capital budget through the end of 2009. The additional equity capital required to complete the tie-in of the Company's Farrell Creek pilot program to the Spectra Energy gas pipeline and to complete any further planned capital programs, such as additional drilling activity and the resultant tie-ins, are now covered under the terms of the July 17, 2008 "Shallow Rights" joint venture (see **Results of Operations** on Page 3). The Company does not anticipate any significant capital requirements related to this project through the end of 2009.

During the year ended December 31, 2008, the Company increased its net working capital position by \$11.4 million through a) equity issues closing during 2008 raising \$8.9 million; b) the exercise of warrants in July 2008 raising \$1.6 million; c) interest income of \$0.1 million during the year; and d) the reimbursement of previously expended drilling and completion costs in the amount of \$5.0 million from a joint venture partner, offset by the outlay of e) net capital expenditures before recoveries of \$2.2 million; f) actual cash administration expenses of \$1.5 million; and g) equity issue costs during the year of \$0.5 million.

#### **Business Risks**

##### ***Productivity***

A material risk facing the Company is the productive capability of the undiscovered and unproven coal and shale resource in the Gething Formation on the Company's existing land base at Farrell Creek and the Company's ability to extract the potential natural gas resource economically. The Company has made significant progress in developing an economic well completion and production system. Together with its joint venture partner, the Company will continue to utilize the knowledge, experience and technology available in the service sector to improve the productivity of the Gething Formation in this emerging gas basin in northeastern British Columbia.

The Shallow Rights joint venture is expected to accelerate the development of the optimal completion and production methods for the Gething Formation with the Company being carried on costs for a period of time. The joint venture is expected to commence with natural gas production in the second quarter 2009.

Following an evaluation of the results of the Gething pilot project, the joint venture partner may elect not to proceed with further development.

##### ***Exploration***

The Company has begun to explore the resource potential of the geological formations below the base of the Cadomin/Nikanassin zone with an initial focus on the Montney Formation. Only a small number of wells have been drilled into these deeper formations in the vicinity of the Company's lands and public

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information is available on just a small number of these wells. Exploration risk includes both determining the existence of commercial quantities of hydrocarbons and the ability to recover any potential resource economically. Recognizing the technical expertise, operating capability and financial resources needed to explore these deeper formations, the Company has entered into a joint venture which will result in the initial exploration of its Deep Rights at Farrell Creek with the joint venture partner bearing the initial capital cost of this program.

### ***Financial Resources and Liquidity***

The Company's ability to continue its operations is highly dependent upon capital markets. Its ability to develop its assets and realize their carrying values is dependent upon the continued support of its shareholders and joint venture partners, favourable capital market conditions and commodity prices, obtaining additional equity financing, converting discovered resources into economically recoverable reserves, and ultimately, generating revenues sufficient to cover operating costs and capital requirements. Without the support of any one of these factors, or a number of them together, the Company's ability to continue its operations could be compromised.

To minimize financial risk, the Company pre-funds all capital commitments in the equity markets and does not utilize debt in these early stages of development. Included in such capital commitments is a minimum level of administrative and operating costs to see the Company through the current equity market and commodity price downward cycles. With \$11.7 million of working capital as at year-end and minimal immediate capital commitments, the Company is in a strong position to continue with its business plan during the current volatility in equity and commodity markets.

### ***Commodity Prices***

The Company's exploration and development efforts are targeted principally on natural gas. There exists an efficient and sophisticated market for natural gas in North America which is sensitive to factors affecting the supply of and demand for this commodity. Similar factors outside North America are having a greater influence on natural gas prices in North America through the growth of liquefied natural gas trade internationally. Currently, natural gas prices influence the Company's investment decisions and once natural gas production is established, it will impact the Company's revenue. The Company considers publically available price forecasts for natural gas in its evaluation of investment economics and returns.

### ***Operating Capability***

The Company is pursuing large unconventional natural gas projects that if successful will require operating staff and experience to fully develop. The Company has a technically strong team suitable for its current operations but does not currently possess the skills and staff needed to conduct an efficient large scale development operation. To mitigate the risk inherent in assembling the necessary operating team, the Company has entered into Deep Rights and Shallow Rights joint ventures pursuant to which substantial parties with the necessary experience and skills will assume operatorship.

### ***Land Acquisition and Tenure***

Rights to explore for and extract hydrocarbons, are generally acquired from the Crown or private parties and require certain work to be performed within a specific time period to retain such mineral rights.

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Mineral rights acquired from the Crown are usually obtained through a closed bid process. In order to expand its exploration activity, the Company must have the financial resources needed to bid on Crown mineral rights and if successful, must have the additional funds to make the required exploration expenditures. The Company acquired its existing mineral rights primarily from the Province of British Columbia during the last five years and must make drilling expenditures on these lands during 2009 and 2010 in order to retain a substantial portion of these mineral rights. To reduce the risk of losing its current mineral rights, the Company has entered into Deep Rights and Shallow Rights joint ventures in return for drilling expenditures on its lands. This will allow the Company to allocate its financial resources to additional land acquisition rather than drilling and development.

### ***Environment and Public Policy***

The exploration, development and production activities of the Company are highly regulated and the trend of public policy is to provide additional incentives and regulations to reduce the impact of industry activity on the environment. The principal components expected to be produced during production operations that would impact the environment are relatively small amounts of formation water and carbon dioxide. The formation water is currently re-injected into deep geologic formations at a commercial facility and in future, will be re-injected at Company owned facilities. Methods to capture and store or use carbon dioxide in commercial applications are being undertaken by the industry and the Company is monitoring these and regulatory developments in order to plan a mitigating strategy.

### **Critical Accounting Policies**

Reference should be made to the Company's significant accounting policies contained in note 2 to the Company's audited financial statements for the year ended December 31, 2008. These accounting policies can have a significant impact on the financial performance and financial position of the Company.

### **Off Balance Sheet Arrangements**

The Company has not entered into any off balance sheet arrangements.

### **Financial Instruments**

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses. It is management's opinion that the Company is not exposed to significant credit, market or liquidity risk arising from its financial instruments and that, due to their short term nature, their fair values approximate their carrying values as at December 31, 2008.

### **Changes in Accounting Policies and Practices**

Effective January 1, 2008, the Company adopted the following new Canadian Institute of Chartered Accountants ("CICA") accounting pronouncements: Section 1535, *Capital Disclosures*; Section 3862, *Financial Instruments – Disclosures*; and Section 3863 *Financial Instruments – Presentation*. The adoption of these new standards results in no significant changes to the audited financial statements of the Company except for additional note disclosure - see notes 9 and 10 to the audited financial statements for the year ended December 31, 2008. See note 2 to the audited financial statements for the year ended December 31, 2008 for a description of the significant accounting policies followed by the Company.

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### **Future Changes in Accounting Policies**

The following is an overview of accounting standard changes that the Company will be required to adopt in the near future:

CICA Handbook: Section 3064, *Intangible Assets*. This section provides additional guidance on when expenditures qualify for recognition as intangible assets and requires that costs be deferred only when relating to an item meeting the CICA definition of an asset. This new standard is effective for interim or annual fiscal periods beginning on or after October 31, 2008 and therefore the Company will evaluate the impact of adopting the new standard in conjunction with its next fiscal year beginning on January 1, 2009.

### **International Financial Reporting Standards (“IFRS”)**

In February 2008, the CICA's Accounting Standards Board confirmed that IFRS will replace Canadian generally accepted accounting principles in 2011 for profit-oriented Canadian publicly accountable enterprises. As such, the Company will be required to report its results in accordance with IFRS beginning in 2011. In the time leading up to the conversion date, some existing Canadian standards will change to converge with IFRS. The Company's financial statements up to and including the December 31, 2010 financial statements will continue to be reported in accordance with Canadian generally accepted accounting principles as it exists on each reporting date. Financial statements commencing with the quarter ended March 31, 2011, including comparative information, will be prepared on an IFRS basis. The Company has developed a changeover plan to complete the transition to IFRS by January 1, 2011, including the preparation of required comparative information. The key elements of the Company's changeover plan include:

- (a) determining appropriate changes to accounting policies and required amendments to financial disclosures;
- (b) identifying and implement changes in associated processes and information systems;
- (c) complying with internal control requirements;
- (d) communicating collateral impacts to internal departments; and
- (e) educating and training internal and external stakeholders.

The Company is currently analyzing accounting policy alternatives and identifying implementation options for the corresponding process changes. CSRI will update its IFRS changeover plan as necessary to reflect new and amended accounting standards issued by the International Accounting Standards Board. As IFRS is expected to change prior to 2011, the full impact of IFRS on the Company's financial statements is not reasonably determinable at this time.

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### **Related Party Transactions**

Transactions with related parties are recorded at exchange amounts for services provided. During the years ended 2008 and 2007, the only transactions the Company had with its directors, persons related to them or companies controlled by them in the normal course of business were as follows:

	<b>2008</b>	<b>2007</b>
Consulting fees	\$ 188,450	\$ 111,700

During the year ended December 31, 2008, a total of \$188,450 (2007: \$111,700) of consulting fees were paid and accounts payable at December 31, 2008 included \$3,716 (2007: \$17,928) of consulting fees payable to a director and executive officer of the Company. Subsequent to the year-end, this consulting contract with a director and executive officer of the Company was terminated. There were no other transactions with directors, persons related to them or companies controlled by them in the normal course of business during 2008 and 2007.

During 2008, certain directors, relatives of directors, or companies controlled by directors subscribed for Nil (2007: 20,250) shares or units in private placement offerings of the Company under the same terms and conditions as other investors.

### **Share Capital**

The Company has authorized share capital of an unlimited number of common shares of no par value.

On February 19, 2008 the Company issued 11,220,000 Units at \$0.50 per Unit. Each Unit consists of one common share and one-half of one share purchase warrant. Each whole warrant entitles the holder to purchase one share for two years at an exercise price of \$0.80 per share. Prior to expiry, if the common shares of the Company close at a price of \$1.20 per share or greater for twenty consecutive trading days, then the Company shall have the option upon thirty days written notice to require the exercise of the warrants by the end of such period at which time any unexercised warrants shall expire. The fair value of the warrants was estimated at the date of closing using the Black-Scholes pricing model, under which the Company assigned a value of \$0.18 per whole warrant or \$1,311,618 of the Unit proceeds to warrants, with the remaining \$4,298,382 of the Unit proceeds assigned to common shares. In July 2008, 40,000 of such whole warrants were duly exercised resulting in \$32,000 of consideration net to the Company.

On July 16, 2008, the Company issued 2,493,319 Units at \$1.05 per Unit and 400,000 Flow-Through Shares at \$1.20 per share. Each Unit consists of one common share and one-half of one share purchase warrant. Each whole warrant entitles the holder to purchase one share for eighteen months at an exercise price of \$1.40 per share. The fair value of the warrants was estimated at the date of closing, using the Black-Scholes pricing model, under which the Company assigned a value of \$0.49 per whole warrant or \$697,169 of the Unit proceeds to warrants, with the remaining \$1,920,816 of the Unit proceeds assigned to common shares. The Flow-Through Shares entitle the holder to certain income tax benefits in the form of Canadian Development Expense. The full proceeds of the Flow-Through Shares placement, or \$480,000, assigned to common shares was fully expended on eligible development costs by the end of 2008. As such, the Company has calculated a potential recovery of future income taxes of \$120,000 due to the issuance of the Flow-Through Shares.

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Since December 31, 2008 to the date of this report, the Company has issued 640,000 common shares for the exercise of stock options and has purchased for cancellation 512,500 common shares under the terms of a Normal Course Issuer Bid (see note 5 to the audited financial statements for the year ended December 31, 2008). During this same period, the Company has granted 100,000 options to purchase common shares to external consultants, 195,000 options to non-executive employees of the Company, 375,000 options to executive officers of the Company and 125,000 options to non-executive directors of the Company for a total of 795,000 options. The issued share capital as at April 23, 2009 consists of 48,682,901 common shares. In addition, the Company has 6,816,660 warrants and 2,667,000 stock options outstanding as at April 23, 2009.

### **Commitments**

The Company has entered into an office sub-lease agreement which expires on May 30, 2011. Under the terms of the sub-lease agreement, the Company is obligated to pay base annual rent of \$28.00 per square foot on 6,793 square feet as well as its share of the operating costs.

### **Corporate Information**

Additional information regarding the Company is available on SEDAR at [www.sedar.com](http://www.sedar.com) or the Company's website at [www.csri.ca](http://www.csri.ca).