

# **Canadian Spirit Resources Inc.**

**For the three and nine month periods ended September 30, 2007**

## **MANAGEMENT DISCUSSION AND ANALYSIS**

This management discussion and analysis (“MD&A”) of the financial conditions and results of operations should be read in conjunction with the interim unaudited financial statements for the three and nine month periods ended September 30, 2007 and the audited financial statements and MD&A for the year ended December 31, 2006.

### **Date**

This MD&A includes information up to November 22, 2007.

### **Quarterly Review**

Neither the interim financial statements for the three and nine month periods ended September 30, 2007 nor this MD&A have been reviewed by the Company’s external auditors.

### **Reader’s Advisory**

The corporate information contained in these pages may contain forward-looking forecast information. The reader is cautioned that assumptions used in the preparation of such information, although considered reasonable by Canadian Spirit Resources Inc. at the time of preparation, may prove to be incorrect. The actual results achieved during the forecast period will vary from the information provided herein and the variations may be material. Consequently, there is no representation by Canadian Spirit Resources Inc. that actual results achieved during the forecast period will be the same in whole or in part as those forecast.

### **Corporate Overview**

Canadian Spirit Resources Inc. (“CSRI” or the “Company”) is a natural resources exploration company currently focusing on the identification and development of unconventional natural gas opportunities in western Canada.

The Company holds a 100% undivided interest, subject to a 10% net profit interest, in a mineral claim covering 450 hectares of land in the Iskut River area of the Liard Mining Division, British Columbia (the “Isk Wollastonite Mineral Properties”). The Company determined that this Wollastonite mineral property contains significant reserves, but are uneconomic to produce at current prices due to lack of access and infrastructure. During the exploration and evaluation phase of operations from 1992 through April 2002, the Company incurred approximately \$8.0 million of losses, including the impairment of the Isk Wollastonite Mineral Properties to \$1.

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 Properties to an evaluation of unconventional natural gas prospects occurred at this time. The Company’s strategic advantages are the extensive knowledge and experience of its technical team in coal, shale and unconventional natural gas exploration and development, the proprietary data base of potential unconventional natural gas resources in western Canada developed during 2002 and early 2003 and the energy development experience of its management, employees and directors.

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### **Results of Operations**

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

The focus of the Company's activities is currently on the execution of a pilot production project in the Farrell Creek area of northeastern British Columbia, located approximately 70 kilometres west of Fort St. John. Preliminary evaluation and cost analysis on the tie-in, facilities and pipeline alternatives are ongoing.

The four test wells completed in the Gething Formation during 2005 and 2006 flowed natural gas and formation water. The Company believes these results are encouraging given the early stage of evaluating this new unconventional basin. Activity to date in 2007 has concentrated on achieving consistent production of natural gas and water from these four test wells with improved reliability of equipment and the reduction of operating costs. Recently, the Company has fracture stimulated a fifth well in the pilot program.

On January 31, 2007, the Company's "Experimental Scheme Application" covering a six section block which incorporates the Company's pilot production project at Farrell Creek was approved by the British Columbia Oil & Gas Commission. The scheme will facilitate the orderly development of the pilot project and enable the Company to continue to keep pertinent engineering data confidential for three years.

In the first nine months of 2007, the Company made equipment changes and applied new production techniques which have resulted in progressively higher and more stable production rates of natural gas. The Company continued its active capital program through the third quarter of 2007. Field operations to complete the first phase of the Gething Formation pilot program at Farrell Creek began in late June and included workovers and further production testing of three of the five wells currently comprising the pilot project. An additional operation to fracture stimulate the upper portion of the Gething Formation in the b-003 well was also undertaken. The planned fracture stimulation of the d-093 well was moved into October 2007, has since been completed and is now under production testing. The Company is utilizing a more controlled flowback approach on the d-093 well and early results are in line with expectations. De-watering and production testing will continue into 2008.

The Company continues to be encouraged by the results of the ongoing pilot program and expects to make further modification to its completion and production techniques with the objective of achieving consistent commercial production rates. Subject to raising additional equity capital, the Company plans to tie-in its pilot project and drill additional wells in early 2008.

#### ***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. The Company has had no activity in the Bittern Lake area in 2007. Due to the inability to acquire a sizable land base for development on reasonable terms, the Company plans to farm out or dispose of these lands.

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

No field work has been conducted at the Isk Wollastonite mine site during 2007 to date. The Company will continue to pursue farming out the mineral claim to third parties.

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### Revenue

Revenues represent interest on surplus cash deposits as well as management fees from a joint venture agreement. Revenues earned from management fees during the first nine months of 2007 were \$Nil (2006: \$45,000).

### General and Administration Expenses

	Three months ended September 30			Nine months ended September 30		
	2007	2006	2005	2007	2006	2005
Consulting fees	\$ 199,078	\$ 54,399	\$ 42,782	\$ 352,183	\$ 172,459	\$ 187,228
Salaries and benefits	153,434	221,237	212,713	567,290	709,788	565,469
Other general administration	105,211	116,794	115,325	356,074	462,061	365,913
	<u>457,723</u>	<u>392,430</u>	<u>370,820</u>	<u>1,275,547</u>	<u>1,344,308</u>	<u>1,118,610</u>
Less: Capitalized costs	<u>(217,527)</u>	<u>(132,864)</u>	<u>(143,910)</u>	<u>(494,534)</u>	<u>(454,480)</u>	<u>(427,541)</u>
	<u>240,196</u>	<u>259,566</u>	<u>226,910</u>	<u>781,013</u>	<u>889,828</u>	<u>691,069</u>
Stock-based compensation	<u>(194,046)</u>	<u>(431,560)</u>	<u>448,559</u>	<u>(299,234)</u>	<u>18,353</u>	<u>1,934,904</u>
	<u>\$ 46,150</u>	<u>\$ (171,994)</u>	<u>\$ 675,469</u>	<u>\$ 481,779</u>	<u>\$ 908,181</u>	<u>\$ 2,625,973</u>

Consulting fees for the first three quarters of 2007 doubled from 2006 due to engineering work relating to the enhancement of the Gething Formation at Farrell Creek. In 2007, the Company continued consulting agreements with its Chief Financial Officer, a financial advisor, and a computer network maintenance company.

Salary and benefits declined by 20% during the first nine months of 2007 compared to 2006, with the decrease being attributable to reductions in drilling and production staff, offset by the increase noted above in engineering consulting fees. The Company capitalizes salaries and benefits associated with staff directly related to exploration activities.

During the first nine months of 2007, the Company capitalized \$490,156 (2006: \$454,480) of general and administration expenses directly related to exploration activities.

Stock based compensation resulted in a net recovery in the first three quarters of 2007 compared with net expense charges in the same periods for both 2006 and 2005. See Summary of Quarterly Results below for further analysis of the effect on stock based compensation on the overall results of the Company. The compensation recovery against earnings for stock options granted for the nine month period ended September 30, 2007 was \$11,234 (2006: expense of \$498,052). The difference is due to lower fair value calculations for the options granted in the first nine months of 2007 compared to the first nine months of 2006 as well as an increase in the number of vested stock options. Total compensation recovery for share appreciation rights for the nine month period ended September 30, 2007 was \$288,000 (2006: \$486,000) based on a closing price of \$0.89 per share on the TSX Venture Exchange on September 28, 2007, down from \$1.37 per share at December 29, 2006. The Company has accrued a long term liability of \$246,000 at September 30, 2007 (2006: \$690,000) relating to share appreciation rights.

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### Other General and Administration Costs

Other general and administrative costs decreased by 22% during the first nine months of 2007 compared to 2006 as indicated in the following table:

	Three months ended September 30			Nine months ended September 30		
	2007	2006	2005	2007	2006	2005
Professional fees	\$ 6,817	\$ 5,923	\$ 21,973	\$ 27,362	\$ 67,055	\$ 63,728
Investor relations & filing fees	21,976	42,343	6,648	83,496	130,871	71,703
Office premises & insurance	52,735	24,472	49,302	158,956	133,730	116,883
Office supplies	15,590	25,040	25,053	47,204	71,449	70,023
Staffing costs	7,428	17,097	11,169	36,258	29,654	25,614
Other	665	1,919	1,180	2,798	29,302	17,962
	<u>105,211</u>	<u>116,794</u>	<u>115,325</u>	<u>356,074</u>	<u>462,061</u>	<u>365,913</u>
Less: Capitalized costs	(14,087)	(12,232)	(10,309)	(21,191)	(34,157)	(29,114)
	<u>\$ 91,124</u>	<u>\$ 104,562</u>	<u>\$ 105,016</u>	<u>\$ 334,883</u>	<u>\$ 427,904</u>	<u>\$ 336,799</u>

Professional fees have declined by 59% in the first nine months of 2007 compared to the first nine months of 2006 due to a decrease in legal and reservoir engineer fees. The decrease in legal fees is related purely to a decline in the number of corporate matters requiring advice or assistance from the Company's legal counsel. The decrease in reservoir engineer fees is due to the update of the Company's reserve report in 2007 rather than a full new report as was the case in 2006.

Staffing costs have increased by 22% in the first three quarters of 2007 from the first three quarters of 2006 due to severance-related costs associated with a former employee. Other expenses for the period ending September 30, 2007 are negligible; other costs for the first nine months of 2006 included interest of \$15,971 on Part X11.6 tax related to the timing of exploration expenditures required under flow-through share look-back rules.

### Summary of Quarterly Results

The Company has no operating revenue. Net results prior to income taxes from the beginning of 2005 were:

Net earnings (loss) by quarter	2007		2006		2005	
	Amount	Per Share	Amount	Per Share	Amount	Per Share
First Quarter	\$ (279,955)	\$ (0.01)	\$ (975,817)	\$ (0.04)	\$ (1,094,574)	\$ (0.05)
Second Quarter	(150,227)	-	31,536	-	(745,055)	(0.03)
Third Quarter	(42,936)	-	174,092	0.01	(469,598)	(0.02)
Fourth Quarter	-	-	(305,026)	(0.01)	(1,497,189)	(0.06)
Net loss before income taxes	<u>\$ (473,118)</u>	<u>\$ (0.01)</u>	<u>\$ (1,075,215)</u>	<u>\$ (0.04)</u>	<u>\$ (3,806,416)</u>	<u>\$ (0.16)</u>

For each period up to and including September 30, 2007, the existence of stock options and warrants affects the calculation of loss per share on a diluted basis. As the effect of this dilution is to reduce the reported loss per share, diluted loss per share equals basic loss per share.

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Stock-based compensation expense or recovery for stock option grants and SARs contributed significantly to the variability in the Company's earnings or losses during the last eleven quarters. Excluding the effects of stock-based compensation the Company's pre-tax losses by quarter would have been:

### Net loss by quarter prior to stock-based compensation

	2007	2006	2005
First Quarter	\$ (299,988)	\$ (216,771)	\$ (174,540)
Second Quarter	(235,382)	(277,597)	(178,745)
Third Quarter	(236,982)	(257,468)	(21,039)
Fourth Quarter	-	(318,597)	(1,256,241)
Net loss prior to stock-based compensation	<u>\$ (772,352)</u>	<u>\$ (1,070,433)</u>	<u>\$ (1,630,565)</u>

The fourth quarter results of 2005 include an impairment charge of \$1,121,164 relating to completion work on the Bluesky Formation at Farrell Creek that proved to be uneconomic.

### Liquidity and Capital Resources

The Company's capital program for the three and nine month periods ended September 30 in each of the last three years is detailed in the following table:

	Three months ended September 30			Nine months ended September 30		
	2007	2006	2005	2007	2006	2005
Lease acquisitions and retentions	\$ 20,134	\$ 43,141	\$ 2,142,684	\$ 72,294	\$ 70,399	\$ 2,207,650
Geological and geophysical	9,745	14,249	49,140	18,990	17,593	81,561
Drilling and completion	1,494,805	3,839,067	2,296,168	2,725,177	7,972,259	2,555,840
Capitalized overhead	217,527	132,864	143,910	490,156	454,480	406,848
Total petroleum and natural gas	1,742,211	4,029,321	4,631,902	3,306,617	8,514,731	5,251,899
Office equipment and furnishings	-	10,985	5,850	3,251	15,640	67,745
Total capital expenditures	<u>\$ 1,742,211</u>	<u>\$ 4,040,306</u>	<u>\$ 4,637,752</u>	<u>\$ 3,309,868</u>	<u>\$ 8,530,371</u>	<u>\$ 5,319,644</u>

At September 30, 2007 the Company has a working capital position of \$1.9 million, consisting of cash in the amount of \$2.5 million, accounts receivable and prepaid expenses of \$0.2 million, net of accounts payable and accrued trade liabilities of \$0.8 million. The accounts payable and accrued trade liabilities relate to work at the Company's Farrell Creek operations during the third quarter of 2007. As a result of the \$3.5 million equity financing from July 2007, the Company has sufficient cash resources to complete its base case capital program for the remainder of 2007. The planned tie-in of the Company's pilot project and the drilling of additional wells in early 2008 will require the raising of additional equity capital. The Company has no bank indebtedness and has no credit agreements to borrow money in place at this time.

### Share Capital

On July 18, 2007, the Company issued 3,053,000 Units at \$1.00 per Unit and 447,000 Flow-Through Shares at \$1.10 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 one year at an exercise price of \$1.10 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 has assigned a value of \$0.21 per whole warrant or

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\$534,275 of the Unit proceeds to warrants, with the remaining \$2,518,725 of the Unit proceeds assigned to common shares. The Flow-Through Shares will 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 \$491,700, has been assigned to common shares.

Since June 30, 2007, the Company has granted 51,000 options to purchase common shares to new or existing employees, or to contractors. Following the July 18, 2007 equity issue, the issued share capital of the Company as at November 22, 2007 consists of 32,333,082 common shares. In addition, the Company has 4,726,500 warrants and 2,385,000 stock options outstanding as at November 22, 2007. Effective July 18, 2007, the expiry date of 3,200,000 of these warrants was extended from August 11, 2007 to December 14, 2007.

### **Business Risks**

The principal risk facing the Company is the productive capability of the coal and shale resources acquired to date and the extraction of these resources economically. Other risks include the uncertainty of further land acquisitions due to the intense competition for both conventional and unconventional opportunities and the availability and cost of drilling and service equipment.

Government incentives, regulations and taxation of the oil and gas industry in Canada have been significant factors affecting industry profitability. The regulatory environment has been relatively stable for several years. However CSRI is unable to predict or control the direction of future public policy. Regulations regarding safety and the environment are strictly adhered to and CSRI sets a high standard of operating practice in order to minimize risks to employees and the environment.

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 continued support of its shareholders, 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.

### **Disclosure Controls and Procedures and Internal Controls**

#### ***Disclosure Control Risk***

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the Company is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure. The Company's Chief Operating Officer (acting in the capacity of Chief Executive Officer) and Chief Financial Officer have concluded, based on their evaluation of the effectiveness of the Company's disclosure controls and procedures as of November 22, 2007, that disclosure controls and procedures provide reasonable assurance that material information is made known to them by others within the Company subject to the reportable weakness identified below regarding segregation of duties. However, a control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

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### *Segregation of Duties*

Segregation of duties is a basic, key internal control and one of the most difficult to achieve in a small company. It is used to ensure that errors or irregularities are prevented or detected on a timely basis by employees in the normal course of business. Due to limited resources, a complete segregation of duties within the Company's operating and accounting groups can not be fully achieved. The result is that the Company is highly reliant on the qualifications, experience and integrity of its staff and on the performance of mitigating procedures during its financial close processes in order to ensure the financial statements are presented fairly in all material respects. No significant change in the current control process is planned until the Company achieves production and cash flow from operations. Management will continue to review existing mitigating controls and, if appropriate, implement changes to its internal control processes whereby more effective mitigating controls will be adopted.

### **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, accounts receivable, accounts payable and accrued expenses. It is management's opinion that the Company is not exposed to significant interest, currency or credit risk arising from its financial instruments and that their fair values approximate their carrying values due to their short term nature, unless otherwise noted.

Effective January 1, 2007, the Company adopted the following new Canadian Institute of Chartered Accountants accounting pronouncements: *Section 3855, Financial Instruments – Recognition and Measurement; Section 3861, Financial Instruments – Disclosure and Presentation; Section 1530, Comprehensive Income; and Section 3865, Hedges*. The adoption of these new standards results in no significant changes to the interim unaudited financial statements of the Company.

### **Related Party Transactions**

During the first nine months of 2007, 2006 and 2005, the Company had transactions with directors of the Company, persons related to them or companies controlled by them in the normal course of business as follows:

For the nine month periods ended September 30	2007	2006	2005
Consulting fees	\$ 84,150	\$ 63,900	\$ 58,400
Salaries and benefits	\$ 89,661	\$ 87,395	\$ 70,500

Consulting fees in the nine month period ended September 30, 2007 included \$84,150 (2006: \$63,900) paid or payable to a director and senior officer of the Company. Accounts payable at September 30, 2007 includes \$3,716 (2006: \$13,362) due to a director and senior officer of the Company for consulting fees earned during the respective periods.

Salaries and benefits of \$89,661 (2006: \$87,395) was the compensation paid to a director and senior officer of the Company during the nine month period ended September 30, 2007.

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Transactions with related parties are recorded at cost, which represents exchange amounts for services provided. In addition, during the first nine months of 2007 there were subscriptions for 1,500 (2006: 14,354) shares or units by directors, relatives of directors, or companies controlled by directors in private placement offerings of the Company under the same terms as other investors.

Since September 30, 2007 until the date of this report, the Company has continued to employ a director as a salaried employee and has continued to contract with another director to provide services as a consultant.

#### **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).