

# **Canadian Spirit Resources Inc.**

**For the three months ended March 31, 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 unaudited interim financial statements for the three month period ended March 31, 2007 and the audited financial statements and MD&A for the year ended December 31, 2006.

### **Date**

This MD&A includes information up to May 15, 2007.

### **Quarterly Review**

Neither the interim financial statements for the three month period ended March 31, 2007 nor this MD&A have been reviewed by the Company’s external auditors.

### **Reader’s Advisory**

The corporate information contained in these pages contains 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 assembly of unconventional natural gas opportunities in western Canada.

The Company holds a 100% undivided interest, subject to a 10% net profit interest, in ten mineral claims covering 1,425 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 this mineral property 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 evaluation of the Isk Wollastonite Mineral Properties to an evaluation of unconventional natural gas prospects occurred during May 2002. The Company’s strategic advantages are the extensive knowledge and experience of its technical team in coal 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 engineering and cost analysis on the tie-in, facilities and pipeline to the Duke Energy sales pipeline was completed and landowner approvals obtained.

All 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 with improved reliability of equipment and the reduction of operating costs.

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 quarter of 2007, the Company made equipment changes and applied new production techniques which have resulted in a more stable production rate of natural gas. Production testing designed to evaluate the completion and fracture stimulation techniques applied in each of the four test wells is continuing for the purpose of optimizing the production from and the spacing of future wells. 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.

#### ***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 was conducted at the Isk Wollastonite mine site during 2007 to date. The Company will continue to pursue farming these claims out the remaining claims to third parties.

### **Revenue**

Revenues represent interest on surplus cash deposits and management fees from a joint venture agreement. Revenues earned from management fees during the first three months of 2007 were \$Nil (2006: \$45,000). The Company does not have any producing properties at this time.

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## MANAGEMENT DISCUSSION AND ANALYSIS

### General and Administration Expenses

For the three month periods ended March 31	2007	2006	2005
Consulting fees	\$ 64,054	\$ 41,562	\$ 82,841
Salaries and benefits	223,620	252,218	160,056
Other general and administrative	143,547	167,289	120,048
	<u>431,221</u>	<u>461,069</u>	<u>362,945</u>
Less: capitalized costs	(124,088)	(167,183)	(142,780)
	<u>307,133</u>	<u>293,886</u>	<u>220,165</u>
Stock-based compensation	(20,033)	759,046	920,035
	<u>\$ 287,100</u>	<u>\$ 1,052,932</u>	<u>\$ 1,140,200</u>

Consulting fees for the first quarter of 2007 increased by 54% from 2006 due to engineering work performed relating to the Gething formation at Farrell Creek, as well as for tight gas consulting services retained relating to the evaluation of the coal and shale formations. 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 11% during the first three months of 2007 compared to 2006, with the decrease being attributable to reductions during 2006 in land and exploration staff, offset by salary increases effective January 1, 2007. The Company capitalizes salaries and benefits associated with staff directly related to exploration activities.

During the first three months of 2007, the Company capitalized \$124,088 (2006: \$167,183) of general and administration expenses directly related to exploration activities.

Stock based compensation resulted in a net recovery in the first quarter of 2007 compared with large net expense charges in the same three month 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 cost charged against earnings for stock options granted for the three month period ended March 31, 2007 was \$141,967 (2006: \$297,213). The decrease is due to lower fair value calculations for the options granted in the first three months of 2007 compared to the first three months of 2006 as well as an increase in the number of vested stock options, offset by an increase in the number of options granted in the current quarter compared to the comparable period in the prior year. Total compensation recovery for share appreciation rights for the three month period ended March 31, 2007 was \$162,000 (2006: expense of \$461,833) based on a closing price \$1.10 per share on the TSX Venture Exchange on March 30, 2007. The recovery of share appreciation rights compensation expense in the first quarter of 2007 is due to the decrease in the closing share price from \$1.37 per share at December 29, 2006 on the previously amortized portion of the share appreciation rights. The Company has accrued a long term liability of \$372,000 at March 31, 2007 (2006: \$534,000) relating to share appreciation rights.

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### Other General and Administration Costs

Other general and administrative costs decreased by 13% during the first three months of 2007 compared to 2006 as indicated in the following table:

For the three month periods ended March 31	2007	2006	2005
Professional fees	\$ 17,239	\$ 25,521	\$ 23,735
Investor relations & filing fees	33,047	37,252	29,657
Office premises & insurance	53,188	49,414	32,805
Office supplies	16,056	24,219	23,706
Staffing costs	23,489	5,714	5,695
Other	528	25,169	4,450
	<u>143,547</u>	<u>167,289</u>	<u>120,048</u>
Less: capitalized costs	<u>(7,074)</u>	<u>(10,802)</u>	<u>(11,290)</u>
	<u>\$ 136,473</u>	<u>\$ 156,487</u>	<u>\$ 108,758</u>

Professional fees have declined by 33% in the first three months of 2007 compared to the first three months of 2006 due to a decrease in legal fees. The decrease is related purely to a decline in the number of corporate matters requiring advice or assistance from the Company's legal counsel. Staffing costs have increased from \$5,714 in the first quarter of 2006 to \$23,489 in the first quarter of 2007 due to severance-related costs paid on behalf of a former employee and to moving costs reimbursed to an officer of the Company. Other expenses for the period ending March 31, 2007 are negligible. Other costs for the first three 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 had no operating revenue in its history. Net results prior to income taxes for the prior nine quarters were:

Net income (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	-	-	31,536	-	(745,055)	(0.03)
Third Quarter	-	-	174,092	0.01	(469,598)	(0.02)
Fourth Quarter	-	-	(305,026)	(0.01)	(1,497,189)	(0.06)
Loss before income taxes	<u>\$ (279,955)</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 March 31, 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 information has not been shown.

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

<b>Net loss by quarter prior to stock-based compensation expense</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
First Quarter	\$ (299,988)	\$ (216,771)	\$ (174,540)
Second Quarter	-	(277,597)	(178,745)
Third Quarter	-	(257,468)	(21,039)
Fourth Quarter	-	(318,597)	(1,256,241)
Loss before income taxes	<u>\$ (299,988)</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 first quarter in each of the last three years is detailed in the following table:

<b>For the three month periods ended March 31</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Lease acquisitions and retentions	\$ 17,690	\$ 19,356	\$ 12,652
Geological and geophysical	8,301	3,344	6,179
Drilling and completion	708,407	3,669,747	56,888
Capitalized overhead	119,710	167,183	133,607
Total petroleum and natural gas	<u>854,108</u>	<u>3,859,630</u>	<u>209,326</u>
Office equipment and furnishings	-	3,542	26,909
Total capital expenditures	<u>\$ 854,108</u>	<u>\$ 3,863,172</u>	<u>\$ 236,235</u>

The Company's budget is reviewed and approved by the Board of Directors on a quarterly basis. Base case capital expenditures are expected to be in the \$1.2 million range for production testing and land retention during the first half of 2007.

Cash administration expenses (G&A excluding stock based compensation) for 2007 are expected to be approximately \$1.75 million, of which \$580,000 is planned to be capitalized as exploration related overhead and recoveries; a decrease of approximately \$100,000 from the 2006 actual results. The net decrease can be attributed to: an anticipated 3% decrease in salaries and benefits due a reduction in land and geological staffing levels that occurred during 2006, offset by the hiring of a new financial officer in late 2006 and nominal salary increases for current employees in 2007; a 37% reduction in consulting fees in 2007 due to the absence of certain consulting fees from 2006 relating to staff recruitment, government scheme applications and certain accounting and finance consulting services; and offset by an increase of 28% in office premises and insurance costs as a result of increased renewal premiums in 2007 for office contents, general comprehensive liability and Directors and Officers liability coverages, as well as higher net rent expense in 2007.

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The Company expects that interest and other income will decrease to approximately \$78,000 in 2007 from \$224,000 in 2006 due to lower cash balances. This will reduce the cash administration expense requirements from \$1.75 million to \$1.67 million. The Company expects to have no recovery of additional amounts from joint venture participants during 2007 (2006: \$45,000).

At March 31, 2007 the Company has a working capital position of \$1.4 million, consisting of cash in the amount of \$1.7 million, accounts receivable and prepaid expenses of \$0.2 million, net of accounts payable and accrued trade liabilities of \$0.5 million. The accounts payable and accrued trade liabilities relate to work at the Company's Farrell Creek operations during March 2007. The Company's working capital position at March 31, 2007 is considered sufficient to cover the second quarter administrative costs of and the remainder of the base case capital budget for the first half of 2007. Additional equity capital will be required to complete the base case capital program for the remainder of 2007. The Company has no bank indebtedness and has no credit agreements to borrow money in place at this time.

At March 31, 2007 there were 3,200,000 warrants outstanding with an exercise price of \$2.50 per share that will expire August 11, 2007.

### **Business Risks**

The principal risks facing the Company are the productive capabilities of the coal and shale resources acquired to date; the uncertainty of further land acquisitions due to the intense competition for both conventional and unconventional opportunities; the availability of drilling and service equipment in a timely manner; and the extraction of hydrocarbons from reservoirs economically.

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, develop its assets and realize their carrying values is dependent upon continued support of its shareholders, favorable 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 May 15, 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 3251, Equity*. As required under the implementation of these new standards however, the unaudited interim financial statements of the Company have not been restated. The adoption of these new standards results in no significant changes to the unaudited interim financial statements of the Company.

### **Related Party Transactions**

During the first three 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 three month periods ended March 31	2007	2006	2005
Consulting fees	\$ 25,050	\$ 20,300	\$ 21,500
Salaries and benefits	\$ 30,561	\$ 27,250	\$ 22,500

Consulting fees in the three month period ended March 31, 2007 included \$25,050 (2006: \$20,300) paid or payable to a director and senior officer of the Company. Accounts payable includes \$9,116 (2006: \$11,847) due to a director for consulting fees earned during the period.

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Salaries and benefits of \$30,561 (2006: \$27,250) was the compensation paid to a director and senior officer of the Company during three month period ended March 31, 2007.

Transactions with related parties are recorded at cost, which represents exchange amounts for services provided. In addition, during the first three months of 2007 there were no subscriptions (2006: Nil) by directors, relatives of directors, or companies controlled by directors for shares or units in private placement offerings of the Company under the same terms as other investors.

Since March 31, 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.

#### **Share Capital**

The Company has authorized share capital of an unlimited number of common shares of no par value. Since March 31, 2007 to the date of this report, the Company has not issued any common shares. In addition, during this period, the Company has not granted options to purchase common shares to new or existing employees. The issued share capital as at May 15, 2007 consists of 28,833,082 common shares. In addition the Company has 3,200,000 warrants outstanding and 2,521,000 stock options outstanding as at May 15, 2007.

#### **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).