# Canadian Spirit Resources Inc.

## For the year ended December 31, 2004

## 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 audited financial statements for the year ended December 31, 2004.

### Date

This MD&A includes information up to March 10, 2005.

### 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 natural gas from coal ("NGC", also referred to as coalbed methane or "CBM") opportunities in western Canada. Effective June 15, 2004, the Company changed its name to Canadian Spirit Resources Inc. from Spirit Energy Corp.

The Company's strategic advantages are the extensive knowledge and experience of its technical team in coal and NGC exploration and development, the proprietary data base of potential NGC resources in western Canada developed during 2002 and early 2003 in conjunction with a major industry joint venture partner, and the energy development experience of its management and directors. A change in the capital allocation priorities of the joint venture partner in May 2003 resulted in CSRI proceeding on its own to identify targets, assemble a land base and commence exploration of its prospects.

The Company also holds a 100% undivided interest, subject to a 10% net profit interest, in five mineral claims covering 2,750 hectares of land in the Iskut River area of the Land Mining Division, British Columbia (the "Isk Wollastonite Mineral Properties").

Prior to May 2002, the Company's primary activity was to evaluate its Isk Wollastonite Mineral Properties. The Company determined that this mineral property contains significant reserves, but are uneconomic to produce at current prices due to lack of access and infrastructure. During 2001 and 2002 the Company impaired the carrying value of the mineral property to $1 from $4,788,596. Included in the net loss of $1,600,438 during 2002 is an impairment charge of $999,999 relating to the impairment of the mineral properties. 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.

Since May 2002, the Company's focus has been to evaluate the resource potential of NGC exploration properties and is considered to be in its development stage of operations. Although some preliminary evaluation work was performed on NGC potential prior to May 2002, the decision to change the strategic direction of the Company from evaluation of the Isk Wollasonite Mineral Properties to an evaluation of NGC occurred during May 2002.

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**New Accounting Policies during the Past Two Years**

During the fourth quarter of 2003, the Company adopted a new accounting policy for stock-based compensation related to common share options. Stock options granted on or after January 1, 2003 have been accounted for based on the fair value method pursuant to new transitional rules approved by the Canadian Institute of Chartered Accountants ("CICA"). The fair value is measured at the grant date and charged to earnings on a pro-rata basis over the vesting period with a corresponding increase in contributed surplus. Consideration paid to the Company on exercise of all options is credited to share capital. Non-cash compensation expenses related to stock options represent a significant portion of total expenses during the current year. This is due to the volatility of the Company's share price, which is a factor used in the computation of stock-based compensation expense, to the increase in the price of the Company's shares, and to additional stock options granted during 2004. The compensation cost charged against earnings for stock options granted in 2004 was $770,592 (2003 - $99,696).

The provision for the potential liability associated with share appreciation rights is calculated quarterly over the three year vesting period of these rights based on the closing price of the Company shares. The compensation cost is charged to stock-based compensation expense on a straight-line basis over the vesting period with a corresponding increase in accrued liabilities. The holder's right to exercise vested stock appreciation rights is conditional upon the Company achieving certain production or profit thresholds. Total compensation expense for share appreciation rights for 2004 was $767,333 (2003 - $78,000) based on a closing price $7.80 per share (in excess of $3.65 per share) on the TSX Venture Exchange on December 31, 2004. The Company has accrued a long term liability of $845,333 at December 31, 2004 relating to share appreciation rights.

Also during the fourth quarter of 2003, the Company adopted the accounting methodology outlined in Section 3110 of the CICA handbook with respect to asset retirement obligations. The Company records the present value of legal obligations associated with the retirement of long-lived tangible assets, such as producing well sites and natural gas processing plants, in the period in which they are incurred with a corresponding increase in the carrying amount of the related long-lived asset. The liability accretes until the Company settles the retirement obligation. The carrying amounts of the long-lived assets are depleted using the unit of production method. Actual costs to retire tangible assets are deducted from the liability as incurred. At December 31, 2004, the Company has accrued a long term liability of $26,236 (2003 - $8,761) for asset retirement obligations.

### Selected Annual Information

(for the years ended or as at December 31)

| | | 2004 | | 2003 | | 2002 |
|---|---|---|---|---|---|---|
| Total revenues | $ | 74,117 | $ | 13,304 | $ | - |
| Net loss | $ | (1,741,820) | $ | (394,063) | $ | (1,600,438) |
| Net loss per share (basic & diluted) | $ | (0.10) | $ | (0.06) | $ | (0.53) |
| Total current assets | $ | 6,814,513 | $ | 2,681,280 | $ | 335,573 |
| Total assets | $ | 20,884,673 | $ | 4,242,668 | $ | 343,991 |
| Total current liabilities | $ | 1,223,229 | $ | 168,124 | $ | 79,864 |
| Total long term financial liabilities | $ | 871,569 | $ | 86,761 | $ | - |

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Revenues represent interest on surplus cash deposits and fees received from amending the mineral option agreement. The Company does not have any producing properties at this time.

### General and Administration Expenses

(for the years ended December 31)

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| Consulting fees | $ 274,102 | $ 170,038 | $ 200,036 |
| Salaries and benefits | 338,262 | 155,615 | 90,714 |
| Stock-based compensation | 1,537,925 | 177,696 | - |
| Management fees | - | 43,500 | 83,607 |
| Other general and administration | 249,817 | 302,216 | 210,682 |
| | 2,400,106 | 849,065 | 585,039 |
| Costs capitalized | 260,070 | 98,690 | - |
| | $ 2,140,036 | $ 750,375 | $ 585,039 |

Consultant's fees increased 61% during 2004 over the prior year due to the addition of a financial consultant effective January 1, 2004, the retention of geological, engineering and land consultants during the year, and professional fees related to a search assignment. During 2004, the Company capitalized $58,435 (2003 - $71,950) of consulting fees relating to geological, engineering and land related exploration activity. In addition, the Company charged $39,122 to share issue costs representing the proportion of consulting work performed by the financial advisor on private placements during the period.

Salary and benefits rose 117% during 2004 compared to 2003. The change is attributed to salary increases effective January 1, 2004 to the original two employees, the retention of a full time geologist and an executive assistant effective January 1, 2004, and to the introduction of a basic benefits package in the first quarter of 2004. The Company capitalizes salaries and benefits associated with staff directly related to exploration activities. In 2004, the Company capitalized $162,513 of salary and benefits compared to $26,740 during 2003. The increase in capitalized costs is due to the addition of a staff geologist, salary increases and the cost of the basic benefits package.

Management fees were incurred in connection with the operation of the former Vancouver office until October 2003.

Other general and administrative costs decreased 17% during 2004 compared to 2003. The decrease is attributed to lower professional fees for financing, audit, accounting and legal fees and lower staffing costs for part time help, travel and entertainment costs in 2004 ($115,546) compared to 2003 ($187,810). There were modest increases in costs (2004 - $134,271 compared to 2003 - $114,406) for office premises and insurance, office supply, investor relations including filing fees and transfer agent costs, and other administrative costs. This increase is due to increased financing activities, development of a corporate website, and a general increase in the level of corporate activity. During 2004, professional fees including legal, audit and accounting and investor relations expenditures including listing and transfer agent fees represent 59% (2003 – 64%) while rent, office supplies, equipment leases and insurance represent 26% (2003 – 21%) while staffing costs, advertising and promotion, and bank charges and interest represent the remaining 15% (2003 – 15%) of administrative costs.

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### For the year ended December 31, 2004

### MANAGEMENT DISCUSSION AND ANALYSIS

### Results of Operations

As a result of the acquisition of additional petroleum and natural gas mineral rights, the focus of the Company's activities is now on the planning and execution of a pilot production project in the Farrell area of northeastern British Columbia. The Company holds a 100 percent working interest in 13,629 hectares of land in this area with mineral rights varying from surface to the base of the Nikanassin and in most cases to basement. To date, the Company has drilled three test wells on its lands to evaluate NGC potential. The first test well was drilled, cored, evaluated and suspended in the eastern portion of its land holdings during 2003. The next two test wells were drilled, cored, evaluated and cased to evaluate a contiguous block of thirty sections in the west side of the Farrell area ("West Farrell") during 2004. The Company plans to complete one of the wells drilled in West Farrell during the first quarter of 2005 in preparation for its NGC pilot production project. The pilot project has been designed to evaluate various well completion and production techniques and to determine the productive capability of the coal resources acquired to date. Confirming the commercial viability of this prospect may require a period of up to one year or greater and may require additional drilling, recompletions and evaluations. The second cased well in West Farrell is expected to be completed in the first quarter of 2005 to evaluate a conventional gas play that was encountered while drilling for NGC on both West Farrell test wells. Also, the Company's geological team has reviewed recently published research on shale gas potential in northeast British Columbia and has correlated this research with data acquired from its three test wells. As a result, the Company has applied to drill a shale test, which will twin its third test well, under the British Columbia test hole regime. A major natural gas transmission line crosses the West Farrell prospect area that will require a tie-in and additional infrastructure before natural gas from this area can be sold economically. The Company will investigate opportunities to sell or utilize any natural gas produced during the pilot phase however initial plans assume this production will be flared.

The Company also holds one section of land in a second area in British Columbia where there is the potential for farm-in and joint venture opportunities. The total land position of the Company in British Columbia totals 13,893 hectares which were assembled at a cumulative cost of $11.1 million. These lands expire in 2008 and 2009 with the potential for extensions if necessary.

In addition, during 2004 the Company acted as agent in acquiring two sections of land in Alberta under a proposed joint venture with an independent third party. Under the terms of the joint venture, the third party will pay 100% of the initial land acquisition and drilling costs up to $2.5 million to earn a 50% working interest in the joint venture lands. The area of mutual interest ("AMI") in the proposed joint venture lands covers four townships in central Alberta. The Company has acquired additional lands in the AMI during the first quarter of 2005 and has plans to drill up to five NGC wells on these lands during 2005. The Company expects to close this agreement in April 2005.

No field work was conducted at the Isk Wollastonite mine site during 2004. A development option held by a third party was amended and extended during 2004 and currently expires on December 31, 2005. The option agreement grants the Optionee the sole and exclusive right and option to acquire a 50% undivided interest, subject to a 3% Net Smelter Return, in the Isk Wollastonite Mineral Properties. In order to earn this interest, the Optionee must incur $3.5 million in exploration expenditures prior to December 31, 2007. Two mineral claims were due to expire in March 2005 with the remaining claims to expire in August or December 2005. The Company obtained an annual extension on the two mineral claims in February 2005 and intends to extend the remaining claims prior to their expiry dates in August or December. Annual extensions are available to the Company for the next ten years.

The Company has no proved reserves at December 31, 2004.

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## MANAGEMENT DISCUSSION AND ANALYSIS

**Summary of Quarterly Results**

The Company has had no operating revenue in its history. Net losses prior to income taxes and the income tax benefit recorded during the fourth quarter for the prior eight quarters were:

| | 2004 | | 2003 | |
|---|---|---|---|---|
| | Amount | Per Share | Amount | Per Share |
| First Quarter | $ 264,063 | $ (0.02) | $ 147,537 | $ (0.02) |
| Second Quarter | 383,367 | (0.02) | 153,329 | (0.02) |
| Third Quarter | 561,720 | (0.03) | 127,625 | (0.02) |
| Fourth Quarter | 868,870 | (0.05) | 311,772 | (0.05) |
| Loss before income taxes | 2,078,020 | (0.12) | 740,263 | (0.11) |
| Future income tax benefit | (336,200) | 0.02 | (346,200) | 0.05 |
| Net loss after tax | $ 1,741,820 | $ (0.10) | $ 394,063 | $ (0.06) |

For the years ended December 31, 2004 and 2003, 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.

In the fourth quarter of 2003, the Company adopted new accounting policies regarding and Stock-based Compensation which have had a significant impact on the quarterly results. The increased market price of the Company's shares during the last three quarters of 2004 resulted in a higher provision for the potential liability associated with share appreciation rights issued in August 2003. Compensation expense attributable to stock options granted during 2004 also contributed to the increased losses for the last three quarters. Excluding the affects of stock based compensation the Company's pre-tax losses by quarter for 2004 have been: First quarter - $124,615 (2003 - $147,537); Second quarter - $204,315 (2003 - $153,329); Third quarter - $178,968 (2003 - $127,625); Fourth quarter - $32,197 (2003 - $134,076).

The Company has financed a portion of its exploration and 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. At December 31, 2004, the Company had estimated tax assets of $2,590,825 (2003 - $2,554,087) of which a valuation allowance has been applied. The tax assets are based upon income tax pools at December 31, 2004 of $20,901,100 (2003 - $8,205,190). The affect of renouncing income tax pools to investors is to reduce tax deductions that are available to offset future taxable income of the Company. Accordingly, when the expenditures are renounced, share capital is reduced and future income tax liabilities are increased by the estimated value of the renounced tax deductions. An issue of flow-through shares in December 2004 and 2003 resulted in a recovery of future income taxes which reduced the reported net loss by $336,200 during 2004 (2003 - $346,200).

**Fourth Quarter Results**

During the fourth quarter of 2004 the Company earned $28,844 (2003 - $13,304) in interest revenue from surplus cash deposits compared to $19,235 earned in the third quarter.

General and administrative expenses prior to stock based compensation declined from $195,979 in the third quarter to $55,166 (2003 - $147,457) in the fourth quarter. This is due to the review of capitalized costs for 2004. In the fourth quarter of 2004, the Company capitalized $113,848 of costs to natural gas properties for salaried staff and consulting fees compared to $35,700 in the first three quarters of 2004. In addition the Company capitalized $39,122 to share issue costs during the fourth quarter representing the proportion of consulting work performed by the financial advisor on private placements during the year.

Stock based compensation increased significantly during the fourth quarter due to the volatility of the Company's share price, which is a factor used in the computation of stock-based compensation expense, to the increase in the price of the Company's shares, and to additional stock options granted during the quarter. Stock based compensation increased from $382,752 (2003 – $Nil) in the third quarter to $836,672 (2003 - $177,696) in the fourth quarter.

The net loss, after the future tax benefit recorded on the issue of flow through shares, for the fourth quarter of 2004 was $532,670 compare to net income of $34,428 during the fourth quarter of 2003.

The Company received an additional $1.2 million proceeds from the issue of flow through shares and the exercise of warrants and expended $1.4 million on drilling and land activity at Farrell during the fourth quarter of 2004.

## Liquidity and Capital Resources

The Company's capital program for each of the last three years is detailed in the following table:

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| Land and lease acquisitions | $ 10,109,017 | $ 990,578 | $ - |
| Geological and geophysical | 56,338 | 240 | - |
| Drilling and completion | 2,058,850 | 444,994 | - |
| Capitalized overhead | 220,948 | 98,690 | - |
| Total petroleum and natural gas | 12,445,153 | 1,534,502 | - |
| Office equipment and furnishings | 58,245 | 12,899 | 9,817 |
| Total capital expenditures | $ 12,503,398 | $ 1,547,401 | $ 9,817 |

The original capital budget for 2004 was $12.0 million including estimated capitalized overhead of $150,000 for the year. Land acquisition expenditures exceeded budget due to higher than anticipated bid costs per hectare. Drilling costs were higher than budgeted due to the drilling and coring of a third test well late in the fourth quarter of 2004. Capitalized overhead was higher due to the greater than expected use of geological, engineering and land contractors during the year.

For 2005, the Company has developed a base case capital budget of $14.9 million which includes an estimated $300,000 for capitalized overhead and $50,000 for administrative capital equipment. The Company's budget is reviewed and approved by the Board of Directors on a quarterly basis. The $14.5 million of exploration activity includes $5.8 million for land acquisition, $1.0 million for geological and geophysical, $6.4 million for drilling and completion, and $1.3 million for field facilities and tie in costs. The Company anticipates having four wells on production during the fourth quarter of 2005. The Company may adjust the base case capital budget after results of the first quarter 2005 completion program are known and as industry activity (such as land postings, rig availability, facility equipment) dictates.

## MANAGEMENT DISCUSSION AND ANALYSIS

Cash administration expenses (G&A excluding stock based compensation) for 2005 are expected to be approximately $1.3 million before capitalization of exploration related overhead; a $458,000 increase from 2004. The net increase can be attributed to: an anticipated increase in salary, benefits and staffing costs of $370,000 due to the hiring of four additional staff in first quarter 2005 and salary increases for existing staff; a reduction of consulting fees of $125,000 due to the hiring of full time staff; an increase of approximately $100,000 due to a new lease on the Company's offices effective January 1, 2005; an increase of $50,000 due to investor relations and filing fees associated with a larger capital base; and a general increase of $63,000 due to costs associated with increased staffing and activity. The Company expects that interest and other income will increase to approximately $200,000 and is anticipating recovery of approximately $180,000 from joint venture participants during 2005. This will reduce the cash administration expense requirements from $1.3 million to $940,000. The Company has not budgeted for any cash flow from operations during 2005.

The Company is in strong financial condition at December 31, 2004 with working capital of $5.6 million, consisting of cash in the amount of $6.0 million, accounts receivable and prepaid expenses of $843,138, net of accounts payable and accrued trade liabilities of $1,223,229. The accounts payable and accrued trade liabilities relate to work at West Farrell that occurred during December 2004. Accounts receivable includes $698,042 relating to the acquisition of joint venture lands in Alberta referred to above. The company has no bank indebtedness and has no credit agreements to borrow money in place at this time.
The Company has raised a total of $20.5 million, after share issue costs, through several non-brokered private placements and the exercise of warrants and options during the past two years. At December 31, 2004 there were 2,539,038 in-the-money warrants outstanding that will expire during 2005. If exercised these warrants would generate approximately $6.2 million of cash resources to the Company during 2005.

The Company expects to close a non-brokered private placement in March 2005 for the issue of approximately 1.3 million Units at $6.75 per Unit. Each Unit consists of one common share and one-half share purchase warrant. Each whole warrant entitles the holder to purchase one share for one year at an exercise price of $8.00 per share. After share issue costs, this private placement is expected to generate approximately $8.6 million of funds for the Company. The positive working capital of $5.6 million, the March 2005 private placement of approximately $8.6 million and the anticipated exercise of in the money warrants of $6.2 million will result in funds available to the Company during 2005 of $20.4 million. These funds will be sufficient to cover administrative costs and the base case capital budget for 2005 totaling $15.5 million and have funding available carry over to 2006 or fund a more aggressive capital budget.

**Business Risks**

The principal risks facing the Company are the productive capabilities of the coal resources acquired to date; the uncertainty of further land acquisitions due to the intense competition for NGC 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.

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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 and, ultimately, generating revenues sufficient to cover operating costs and capital requirements.

**Related Party Transactions**
During 2003 and 2004, 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:

| | 2004 | 2003 |
|---|---|---|
| Consulting fees | $ 79,800 | $ 69,325 |
| Salaries and benefits | $ 97,901 | $ 72,000 |
| Management fees | $ - | $ 43,500 |
| Administration and accounting fees | $ 1,940 | $ 5,560 |

Consulting fees in 2004 included $79,800 (2003: $60,000) paid or payable to a director and senior officer of the Company and $Nil (2003: $9,325) to a former director and a company controlled by the former director for management and consulting services provided to the Company. Accounts payable includes $6,765 (2003: $12,870) due to a director for consulting fees earned during 2004.

Salaries and benefits of $97,901 (2003: $72,000) was the compensation paid or payable to a director and senior officer of the Company during 2004. Accrued liabilities includes a bonus accrual of $6,000.00.

Management fees of $Nil (2003: $43,500) were paid to a former director and former officer of the Company for management and administrative services during 2004.

Accounting fees of $1,940 (2003: $5,560) were paid to a company controlled by the spouse of a director and senior officer for accounting services during 2004.

Transactions with related parties are recorded at cost, which represent fair market value for services provided. In addition during 2004, certain directors, relatives of directors, or companies controlled by directors subscribed for 15,000 (2003: 456,000) shares or units in private placement offerings of the Company under the same terms as to other investors.

Since December 31, 2004 to 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 December 31, 2004 to the date of this report, the Company has issued 137,538 common shares for the exercise of 85,000 options and 52,538 warrants. In addition, during this period, the Company has granted 550,000 options to purchase common shares to new and existing employees. The issued share capital as at March 10, 2005 consists of 22,474,886 common shares. In addition the Company has 2,486,500 warrants outstanding and 2,300,000 stock options outstanding as at March 10, 2005.

**Corporate Information**
Additional information regarding the Company is available on SEDAR at www.sedar.com or the Company's website at www.csri.ca.