



RICHARDS  
OIL & GAS LIMITED

ANNUAL REPORT

## President's Message – 2007

Richards Oil & Gas Limited's ("Richards" or the "Company") second full year of operations was a building year where the Company achieved a number of objectives despite challenges from low natural gas prices, declining conventional production and volatile capital markets.

During 2007, the Company focused on increasing the rate and stability of its gas production by concentrating on its Horseshoe Canyon coalbed methane (CBM) properties and drilling 19 gross (9.4 net) wells. This drilling activity, along with the tie-in of six wells that were standing at the end of 2006 and the recompletion of gas producing sands in three wells at the Company's Morningside property resulted in an increase in production from CBM reserves of over 700%. At year-end eight gross (4.0 net) of the wells drilled in 2007 are standing and will be tied-in along with 11 additional 2008 development wells. These wells are expected to add 1,000 to 1,200 mcf per day of net production in 2008.

By the end of 2007, the Company more than replaced the production declines experienced from its conventional wells at Gadsby with stable CBM production. This production increase, along with improvements in operating cost efficiencies and the reduction of general and administrative costs, allowed Richards to achieve positive monthly operating cash flow in early 2008. With the tie-in of the standing wells and additional production from drilling, which is to be funded from working capital and cash flow, the Company will continue to grow monthly cash flow for reinvestment in further development in 2008 and future years.

A key accomplishment for the Company during 2007 was the establishment of the Thorsby Horseshoe Canyon CBM property as a core development area. With positive results from a test well drilled in early 2007, an additional four gross (2.4 net) wells were drilled and completed in December of last year. These additional wells showed similar, positive results and formed the basis for a development plan in the area. CBM and shallow gas rights were acquired on two sections at a November land sale. Farm-in negotiations that began in mid-2007 were completed in January 2008 and will provide Richards with the opportunity to grow Thorsby from seven sections into a core production area with over 23 sections of land with the potential for over 80 CBM wells. Richards operates this area and, if fully earned, would have an average working interest of 88%.

The net result of the Company's 2007 activities was to increase its proved plus probable ("P+P") reserve volumes by 12% to 1,805 MBOE. Over 90 % of these reserves are stable long-life CBM, resulting in a Reserve Life Index of 21 years. The activity in the Thorsby area added new reserves of 877 MBOE or 49% of total P+P reserves. The reduction of natural gas forecast pricing from 2006 to 2007 did reduce the Company's P+P reserve values to \$8.9 million (NPV10). Natural gas prices in 2008 have increased over 40% since the reserves were valued at December 31, 2007. Also, with the proposed changes to the Alberta Government's natural gas royalty program that is to come into effect in 2009, Richards will see improved cash flow from a decrease in the rate of royalties paid on the Company's Horseshoe CBM wells. Both of these factors are expected to have a significant positive effect on the Company's reserve value.

Finally, Richards had a challenging but progressive year regarding its higher risk Ardley CBM exploration play. During the year, two vertical test wells and one multi-leg horizontal well were drilled. Richards' was pleased with the vertical test wells which further demonstrated the existence of dry (ie. non-water producing) gas producing coal and earned the Company optioned lands. The horizontal well however, proved challenging for Richards. This well was initially drilled in July and re-entered in December using an under-balanced drilling approach. Based on information gathered in July, a foam-based drilling fluid system was designed to provide effective drill bit lubrication which cleared the drill cuttings while not saturating the coal formation with water or other fluids that could adversely impact the gas productivity. This was the first application of this foam system in a horizontal well and it proved to be very effective as there was no fluid loss during drilling. Unfortunately, while drilling, the well bore came into contact with rock and clay above the coal which caused the drill pipe to become un-retrievable in one of the multi-lateral legs of the well.

In March and early April 2008 the well was cleaned out and the unrecoverable drill pipe was perforated to allow for gas flow. Although initial flow test results show that this well has no appreciable gas flow, the Company will continue to perform pressure build up and flow tests of this well. The Company is also evaluating stimulation techniques which may be used to push fluids that were introduced to the coal during post drilling operations away from the well bore to enhance formation pressure and gas production. Pipeline alternatives are also being evaluated as the Company hopes to bring this well on production in 2008 to allow for a long-term flow test. It does remain uncertain however, if the expected gas volumes from this multi-lateral well will justify tie-in and a long-term flow test.

Although Richards has yet to establish commercial production in the Ardley area based on initial flow rates, drilling cost and estimated production costs, the activity to date demonstrates the existence of "dry" coal, permeability, gas flow and that a horizontal well can be drilled with minimal fluid loss during drilling. Given the significant resource potential of the Ardley, the Company will continue to work to resolve the technical requirements of drilling the Ardley coals and will also complete a comprehensive analysis and model using data gathered from the ten vertical and two horizontal wells drilled on this property. The Company will use working capital and look for financing alternatives including joint venture partners to continue the development of this area.

With much appreciated shareholder support, the Company raised \$10 million of equity in August 2007. These funds have and will be used to further develop production and reserves as well as establish ongoing cash flow. This financing was key in providing Richards' the ability to execute its development plan and be positioned for growth by earning lands through drilling and increasing production.

For 2008 and beyond, Richards is optimistic regarding the fundamental business environment and industry opportunities. With decreased field service costs, enhanced availability of services and equipment, improved land and farm-in availability and strengthening natural gas prices the Company is poised to grow its operational cash flow, land position and ultimately its production and reserve base.

In closing, I would like to thank the staff and the board of directors of Richards for their hard work and dedication over this past challenging year. Furthermore I am most grateful to the Company's shareholders for their continued support. I look forward to an exciting future for Richards as the Company continues to leverage its expertise to generate additional opportunities for growth and increased shareholder value.

Sincerely,



Brad Turner  
President & Chief Executive Officer

#### ADVISORIES

*BOEs may be misleading, particularly if used in isolation. A BOE conversion ratio of 6 Mcf: 1bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.*

*Statements in this message contain forward-looking information including expectations of future production, procurement of drilling permits, plans for and results of exploration and development activities and other operational developments. The reader is cautioned that assumptions used in the preparation of such information may prove to be incorrect. Events or circumstances may cause actual results to differ materially from those predicted, as a result of numerous known and unknown risks, uncertainties, and other factors, many of which are beyond the control of the Company. These risks include, but are not limited to; the risks associated with the oil and gas industry, commodity prices, and exchange rate changes. Industry related risks include, but are not limited to; operational risks in exploration, development and production, availability of skilled personnel and services, failure to obtain industry partner, regulatory and other third party consents and approvals, delays or changes in plans, risks associated with the uncertainty of reserve estimates, health and safety risks and the uncertainty of estimates and projections of reserves, production, costs and expenses. The reader is cautioned not to place undue reliance on this forward-looking information. The forward-looking statements contained herein are subject to change. Except as required by applicable securities laws, the Company assumes no obligation to update or revise any forward-looking statements should circumstances or management's opinions or estimates change.*

## **RICHARDS OIL & GAS LIMITED MANAGEMENT DISCUSSION & ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION**

This management discussion and analysis of the results of operations and financial condition (“MD&A”) for Richards Oil & Gas Limited (the “Company”) should be read in conjunction with the Company’s audited financial statements for the years ended December 31, 2007 and 2006 and the notes related thereto. All amounts are stated in Canadian dollars unless otherwise specified. This MD&A is based upon information available to, and is dated, April 14, 2008. Additional information relating to the Company can be viewed or downloaded at [www.richardsoilandgas.com](http://www.richardsoilandgas.com) or on SEDAR at [www.sedar.com](http://www.sedar.com)

Throughout this MD&A, BOE, or barrel of oil equivalent, is defined as 6 Mcf to 1 bbl. BOEs may be misleading particularly if used in isolation. A BOE conversion ratio of 6 Mcf:1 bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

The financial information presented has been prepared in accordance with Canadian Generally Accepted Accounting Principles (“GAAP”).

### **2007 HIGHLIGHTS**

- Increased average annual production volumes 65% to 149 boe per day up from 90 boe per day in 2006
- Increased unconventional coal bed methane (“CBM”) proved plus probable reserves by 25% to 10.6 bcf (1,765 Mboe)
- Established a new Horseshoe Canyon CBM play in the Thorsby area of Alberta and both prior to and after year end 2007 substantially increased its landholdings at Thorsby with over 23 net sections of earned and optioned lands.
- Drilled and completed 19 (9.4 net) Horseshoe Canyon CBM wells on the Company’s Thorsby, Morningside and Lacombe properties increasing current production levels to 230 boe per day
- Replaced declining conventional gas production with stable, long life CBM production (90% of current gas production is now from CBM versus 22% in January 2007)
- Recompleted three wells in the Morningside property adding over 300 mcf (gross) of gas production from dry Horseshoe Canyon sand zones
- Enhanced financial flexibility by completing a \$10 million private placement in August; the net proceeds of which continue to be applied to accelerate the development of the Company’s Horseshoe Canyon CBM properties
- Maintained financial strength with working capital of \$4.1 million and an available bank line of \$1.5 million at the end of the December 2007

## OUTLOOK

The operating environment for the Company has improved dramatically over the past year with drilling and completion costs declining as much as 40% since 2006 and natural gas prices increasing over 30% since the end of 2007. Additionally, reduced industry activity has made land acquisition and farm-in arrangements more available and less costly allowing the Company to grow its land base and drilling location inventory.

The Company will utilize its current working capital and its expected operational cash flow to continue to increase production volumes and earn lands. Planned capital expenditures for 2008 are \$6.5 million and includes drilling 8 to 10 net Horseshoe Canyon wells, tie-in of 10 to 12 wells (new plus standing at December 2007). This use of capital will increase production to over 400 boe per day and will enable the Company to earn up to nine sections of land by the end of 2008.

Richards Oil & Gas Limited has proven its ability to find, acquire and develop economic production from the Western edge of the Horseshoe Canyon CBM fairway and will look for additional areas that can become core properties.

In regards to additional development of the its Ardley properties, the Company has a large land base, 3D seismic data, drilling logs, flow and pressure data, established road access and gained experience in drilling horizontal wells in the Ardley coal, all of which will be valuable for future development. The Company will use working capital and look for financing alternatives including joint venture partners to continue the development of this area.

The increased production from 2008 drilling and tie-in activities along with improved net backs and reduced general and administrative costs will continue to increase the Company's positive cash flow which will be reinvested in future production and revenue growth. The Company has over 140 potential Horseshoe Canyon CBM drilling locations, over 70 potential Ardley CBM drilling locations and potential Mannville CBM locations which provide significant room for growth beyond 2008.

## SELECTED FINANCIAL INFORMATION

\$ Amount except for per share information	Year ended December 31		
	2007	2006	Change
Production revenues	2,102,333	1,217,674	73%
Net income (loss)	(15,556,641)	(4,148,052)	(275%)
Net income (loss) per share	(0.29)	(0.12)	(141%)
Property and equipment additions	9,761,919	14,416,551	(33%)
Total assets	24,964,985	31,005,690	(20%)
Total liabilities	10,581,701	10,272,718	3%
Common shares outstanding – basic	72,661,602	40,991,964	77%
Common shares outstanding – diluted	97,429,336	52,293,692	86%

## SELECTED OPERATIONAL INFORMATION

	Year ended December 31		
	2007	2006	Change
Natural gas (mcf/day)	818	415	97%
Crude oil (bbl/day)	12	20	(40%)
Total (boe/day)	149	90	65%
Natural gas price (\$/mcf)	\$6.34	\$6.16	3%
Oil price (\$/bbl)	\$43.01	\$36.84	17%
Royalties (\$/boe)	\$7.20	\$7.01	3%
Operating expenses (\$/boe)	\$18.36	\$19.45	(6%)
Operating netback (\$/boe)	\$13.00	\$10.63	22%

## FORWARD-LOOKING STATEMENTS

This MD&A contains forward-looking financial and operational information including production and capital expenditures projections. The projections are based on the Company's expectations and are subject to a number of risks and uncertainties that could materially affect the results. Actual results achieved during the forward-looking period may differ materially from the information provided herein as a result of numerous known and unknown risks and uncertainties and other factors. Such factors include, but are not limited to: general economic, market and business conditions; industry capacity; competitive action by other companies; fluctuations in oil and gas prices; the ability to produce and transport crude oil and natural gas to markets; the result of exploration and development drilling and related activities; fluctuation in foreign currency exchange rates; the imprecision of reserve estimates; the ability of suppliers to meet commitments; actions by governmental authorities including increases in taxes; decisions or approvals of administrative tribunals; change in environmental and other regulations; risks associated with oil and gas operations; the weather in areas of operation; and other factors, many of which are beyond the control of Richards Oil & Gas Limited. The Company disclaims any intention or obligation to publicly update or revise any forward-looking statements or information whether as a result of new information, future events or otherwise, except as may be expressly required by applicable securities laws.

## RESULTS OF OPERATIONS

### Revenues

\$ Amounts	Year ended December 31		
	2007	2006	Change
Natural gas revenues	1,892,161	932,554	103%
Oil revenues	183,765	262,094	(30%)
Natural gas liquids revenues	26,407	23,026	15%
Total production revenue	2,102,333	1,217,674	73%

### Production

	Year ended December 31		
	2007	2006	Change
Natural gas (mcf/day)	818	415	97%
Oil (bbl/day)	12	20	(40%)
Natural gas liquids (bbl/day)	1	1	nil %
Total (boe/day)	149	90	65%

### Average Sales Price

	Year ended December 31		
	2007	2006	Change
Natural gas (\$/mcf)	\$6.34	\$6.16	3%
Oil (\$/bbl)	\$43.01	\$36.84	17%

### Average Benchmark Sales Price

	Year ended December 31		
	2007	2006	Change
AECO (daily) natural gas (\$/mcf)	\$6.45	\$6.53	(1%)
WTI crude oil (\$US/bbl)	\$72.31	\$66.24	9%
Edmonton par price (\$CAD/bbl)	\$76.25	\$72.79	5%
Exchange rate (\$US/\$CAD)	1.07	1.13	(5%)

Production for the year ended December 31, 2007 averaged 149 boe per day representing a 65% increase over the same period in 2006. This increase is a result of the Company's continued success in bringing on-line CBM natural gas production throughout 2007. During 2007 conventional gas production declined significantly due to natural reservoir depletion and water production issues. This lost production was replaced by stable low decline CBM wells. The year over year decline in oil production is primarily a result of natural declines and the shutting in of one well that was no longer producing economically. The Company has not hedged its production, and its crude oil, natural gas liquids and natural gas production is sold into spot markets.

The Company's realized average sales price for the year ended December 31, 2007 was \$6.34 per mcf, a 3% increase from the year end 2006 realized average sales price. This similar year over year natural gas price realized by the Company is consistent with the one percent decline witnessed in the changes in the year over year AECO (daily) natural gas market price.

Substantially all of the Company's production is natural gas and most of the natural gas sold by the Company is CBM, natural gas produced from coal formations. CBM is in all material respects the same as natural gas save for a variance in heating content and other elements contained within the produced gas stream. The Company currently receives pricing that typically averages 2% to 4% less than the weighted average of AECO (daily) natural gas market price which reflects the slightly lower heating content of CBM gas.

## Royalties

\$ Amount except percentages	Year ended December 31		
	2007	2006	Change
Crown royalties	182,953	148,584	23%
Gross overriding and freehold royalties	209,658	107,862	94%
Total gross royalties	392,611	256,446	53%
Alberta royalty tax credit	-	(26,260)	n/a
Total net royalties	392,611	230,186	71%
Net royalties (\$/boe)	\$7.20	\$7.01	3%
Average corporate royalty rate	19%	19%	-%

Royalties are paid to various government entities and other land, mineral rights and interest holders in respect of the Company's natural gas, natural gas liquids and oil production. For the year ended December 31, 2007 the Company incurred total net royalty expenses of \$392,611 which represents 19% of total production revenues recorded or \$7.20 on a per boe basis. This represents an increase of 71% in total net royalties incurred from 2007 to 2006. This increase in net royalties is consistent with the increase in total production of 65%. Royalty rates are expected to average 17 to 19 percent in 2008.

## Alberta Royalty Changes

As a result of the recently announced Alberta royalty rate changes the Company estimates an approximate 10 per cent increase in cash flow from current production (based on a benchmark constant price of AECO (daily) \$6.00 per mcf) as the Crown royalty rate for lower productivity wells (50 to 150 mcf per day) will be reduced to 5% from 12% at natural gas prices below \$7.38 per mcf. The announced changes are to come into effect January 1, 2009. In the Alberta Royalty Announcement the Government did not outline a specific new royalty framework for CBM, but it was stated that CBM was the future of gas production in the province.

## Operating Expenses

\$ Amount	Year ended December 31		
	2007	2006	Change
Operating expenses	1,000,946	638,651	57%
Operating expenses (\$/boe)	\$18.36	\$19.45	(6%)

Operating costs for the year ended December 31, 2007 increased 57% over 2006 and totaled \$1,000,946. This increase in operating expenses was entirely due to increased production levels which increased 65% year over year. On a per boe basis operating costs declined 6% to \$18.36 per boe from the \$19.45 per boe incurred in 2006. This reduction in per boe operating expenses is primarily the result of the Company realizing operating efficiencies at its Morningside and Lacombe CBM areas. The efficiencies are a result of an increased base of production, improved facility utilization and a fixed overhead level that has remained relatively constant. In 2008 the Company will undertake specific field operating initiatives, that when combined with further production volume increases, will further reduce the Company's per boe operating costs.

## OPERATING NETBACKS

	Year ended December 31, 2007			
	Natural gas (\$/mcf)	Oil (\$/bbl)	Natural gas liquids (\$/bbl)	Total (\$/boe)
Price	\$6.34	\$43.01	\$52.19	\$38.56
Net royalties	(\$1.21)	(\$5.15)	(\$18.09)	(\$7.20)
Operating expenses	(\$3.05)	(\$19.44)	(\$17.14)	(\$18.36)
Operating netback	\$2.08	\$18.42	\$16.96	\$13.00

Note: Rounding has been applied to amounts within this table

	Year ended December 31, 2006			
	Natural gas (\$/mcf)	Oil (\$/bbl)	Natural gas liquids (\$/bbl)	Total (\$/boe)
Price	\$6.16	\$36.84	\$48.46	\$37.09
Net royalties	(\$1.19)	(\$6.25)	(\$11.03)	(\$7.01)
Operating expenses	(\$3.16)	(\$21.09)	(\$19.69)	(\$19.45)
Operating netback	\$1.80	\$9.50	\$17.75	\$10.63

Note: Rounding has been applied to amounts within this table

## GENERAL AND ADMINISTRATIVE EXPENSES

\$ Amount	Year ended December 31		
	2007	2006	Change
Total general and administrative expenses incurred	<b>2,403,434</b>	2,809,611	(15%)
Less overhead recoveries	<b>(209,362)</b>	(194,690)	8%
Less capitalized overhead	<b>(270,037)</b>	(313,990)	(14%)
Net general and administrative expenses	<b>1,924,035</b>	2,300,931	(17%)

Net general and administrative expenses for the year ended December 31, 2007 totaled \$1,924,035 versus the \$2,300,931 incurred in 2006, a year over year reduction of 15%. This reduction in general and administrative expenses is a result of management's commitment to improve both its operating and administrative expense metrics.

## STOCK-BASED COMPENSATION

\$ Amount	Year ended December 31		
	2007	2006	Change
Stock-based compensation	<b>453,683</b>	1,239,607	(63%)

The Company's stock-based compensation plan provides current employees, officers, directors, and consultants with the right to elect to receive common shares through the Company's stock option plan. Stock-based compensation expense totaled \$453,683 for the year ended December 31, 2007 compared to \$1,239,607 recorded in 2006, a decrease of \$785,924 or 63%. The reduction in the year over year comparison is due primarily to the timing, number, original fair market value and age of the options. Most of the Company's options vest over a one year period and since most of the options have reached this first year vesting mark, the expense related to the small portion of options that vest over a two year period remains to be charged to the statement of operations and deficit.

There are a total of 5,203,333 stock options outstanding at an average exercise price of \$0.91 per share at December 31, 2007.

## INTEREST AND FINANCING CHARGES

\$ Amount	Year ended December 31		
	2007	2006	Change
Interest on convertible debenture	520,000	269,261	93%
Amortization of deferred financing charges	-	65,327	79%
Accretion of discount on convertible debentures	404,412	148,696	93%
Interest expense	150,071	106,866	40%
Total	1,074,483	590,150	82%

On June 26, 2006 the Company issued \$6.5 million of 8.0% convertible unsecured subordinated debentures. Commensurate with the placement of this debt the Company's interest and financing charges for the year ended December 31, 2007 are proportionately higher than the interest and financing charges for 2006 when the convertible debentures were outstanding for only part of the year.

## INCOME TAXES

The Company is currently not taxable, and the Company does not anticipate paying current income tax over the next several years. The Company's current tax rate is a combined Canadian federal and Alberta plus Saskatchewan provincial rate of 32.60%.

As at December 31, 2007 the oil and gas properties owned by the Company have a tax basis of approximately \$24,210,000 (2006 – \$16,110,000) available for future use as deductions from taxable income. Included in this tax basis are non-capital loss carry forwards of approximately \$13,385,000 (2006 – \$5,575,000) which expire in the years 2024 to 2027.

## CAPITAL EXPENDITURES

The Company spent \$9,761,919 on capital expenditures during the year ended December 31, 2006. \$4,523,545, or approximately 46% of the 2007 capital expenditures, was spent drilling and completing three gross wells (3.0 net - two vertical and one horizontal) on the Company's Ardley CBM prospective lands. The remainder of the 2007 capital expenditures were primarily spent on drilling, completing and tie-in of 19 gross (9.4 net) Horseshoe Canyon CBM wells. Of the wells drilled and completed in 2007, 11 gross wells, (5.4 net), were awaiting tie-in at December 31, 2007. All of the Horseshoe Canyon CBM wells that were drilled in 2007 were successful. The following table summarizes the Company's investment activities by types and compares the specific expenditure to the expenditures made in the previous year:

\$ Amount	Year ended December 31		
	2007	2006	Change
Land	253,125	347,381	(27%)
Geological and geophysical	201,231	3,112,339	(94%)
Drilling and completion	7,775,468	8,885,930	(13%)
Well equipment and facilities	1,558,726	2,048,821	(24%)
Disposition of oil and gas properties	(38,000)	-	n/a
Office equipment and leaseholds	11,369	22,080	(49%)
Total	9,761,919	14,416,551	(32%)

## LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2007, the Company had a working capital surplus of \$4,106,205 including cash of \$6,225,567 and no drawings on its current credit facility.

The Company anticipates it will have adequate liquidity to fund future operating and planned and committed capital spending in 2008 through a combination of working capital, cash flow anticipated from operations and drawings on the Company's \$1,500,000 credit facility. It is expected that the Company's increased natural gas production levels coupled with strengthening gas prices will provide adequate cash flow to sustain the Company through 2008 and into future years.

As at April 14, 2008 the total issued and outstanding shares in the Company was 72,661,602.

## OFF-BALANCE SHEET ARRANGEMENTS

The Company does not utilize any off-balance sheet arrangements.

## QUARTERLY FINANCIAL SUMMARY

\$ Amount except for per unit amounts	Q4 2007	Q3 2007	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Sales – Natural gas (mcf/day)	946	655	609	1,065	699	481	293	180
Sales – Oil and natural gas liquids (bbls/day)	11	13	13	16	19	22	20	22
Sales – Total (boe/day)	169	122	114	193	136	102	69	52
Average Natural gas price (\$/mcf)	\$5.96	\$4.92	\$7.10	\$7.13	\$6.53	\$5.61	\$5.79	\$6.77
Average Oil and natural gas liquids price (\$/bbl)	\$45.97	\$47.42	\$41.17	\$41.96	\$38.09	\$49.89	\$50.27	\$13.46
Total production revenue	565,369	353,086	441,256	742,622	486,243	347,720	246,895	136,816
Interest and other revenue	104,363	104,278	36,802	48,203	39,209	48,184	8,335	60,833
Royalty expense, net of ARTC	90,233	48,754	46,004	207,620	106,854	67,434	21,747	34,151
Operating expense	338,615	219,898	223,707	218,726	204,160	214,488	119,714	100,289
General and administrative expenses	249,179	353,977	538,193	782,686	560,828	895,582	522,901	321,620
Stock-based compensation	54,037	152,492	161,904	85,250	535,833	287,046	293,977	122,751
Interest and financing charges	244,092	260,829	290,391	279,171	121,939	334,791	90,124	43,296
Depletion, amortization & accretion expense	390,271	318,993	283,547	470,434	357,693	134,417	92,155	208,430
Impairment of oil and gas properties	8,250,000	3,700,000	2,150,000	-	1,725,000	-	-	-
Future income tax reduction	(7,081)	(1,188,588)	(960,795)	(299,919)	(631,088)	(196,617)	(967,394)	(199,834)
Net income (loss)	(8,939,614)	(3,408,991)	(2,254,893)	(953,143)	(2,455,767)	(1,341,237)	82,006	(433,054)

Q4 2007 - Natural gas production volumes increased as new CBM wells were brought on production. Lower general and administrative levels are a result of Company efforts to reduce certain general and administrative items and as a result the more representative of the Company's future administrative burden. The Company recorded an impairment charge of \$8,250,000 on its oil and gas properties. This impairment charge was due to reserve revisions made on some of the Company's Horseshoe Canyon CBM lands and the Company's decision to remove from unproved property cost further expenses incurred on its Ardley CBM properties.

Q3 2007 - Natural gas production volumes increased as new CBM wells were brought on production. Lower general and administrative levels are a result of Company efforts to reduce certain general and administrative items. The Company recorded an impairment charge of \$3,700,000 on its oil and gas properties. This impairment charge was due to the further decline in the future natural gas prices and the Company's decision to remove from unproved property cost certain expenses incurred on its Ardley and Thorsby CBM properties.

Q2 2007 - Natural gas production volumes declined from the first quarter of 2007 as a result of a combination of natural declines from conventional wells, equipment failures and extensive repairs and maintenance experienced. Royalty expenses were lower primarily as a result of a one-time royalty adjustment. The Company recorded an impairment charge of \$2,150,000 on its oil and gas properties as a result of the decline in the future natural gas prices.

Q4 2006 - During the fourth quarter the Company recorded an impairment charge on its oil and gas properties as a result of the Company's decision to remove from unproved property costs certain costs incurred on its unproved Ardley property.

Q3 2006 - The Company incurred \$452,000 in one time charges that increased the general and administrative expenses in the period. The increase in interest expense is a result of recognizing a full three months of the charges relating to the placement on June 26, 2006 of the Company's convertible debenture offering.

Q2 2006 - The Company recorded a future income tax recovery of \$967,394 which was primarily the result of a reduction in the substantially enacted tax rates during the quarter.

#### **RELATED PARTY TRANSACTIONS**

In 2006, the Company and an engineering and development consulting firm mutually agreed to restructure their relationship. The original services contract between the parties provided a 2% gross overriding royalty to the consulting firm on all lands introduced by them to the Company. Part of the consideration for the early termination of this services contract and the restructuring of the former relationship involved limiting the 2% gross overriding royalty payable to the consulting firm to specific oil and gas properties. Pursuant to a direction from the consulting firm, the Company was directed to pay this 2% gross overriding royalty to four corporations of which three were owned by existing or past officers of the Company. For the year ended December 31, 2007 payments to corporations controlled by two officers of the Company with respect to this 2% gross overriding royalty totaled \$9,389 (2006 - \$ 7,482). At December 31, 2007, \$4,271 (2006 - \$ 3,125) was owed to the same corporations controlled by two officers of the Company.

For the year ended December 31, 2007 payments to a corporation controlled by an officer of the Company with respect to the provision of consulting services totaled \$6,075. At December 31, 2007, \$6,075 was owed to the same corporation controlled by the officer of the Company.

## **COMMITMENTS**

The Company is committed to payments under an operating lease for office space over the next five years. The operating lease commitment, before operating costs, for the next five years are as follows; 2008 - \$113,493, 2009 - \$136,192, 2010 - \$140,415, 2011 - \$144,638 and 2012 - \$148,860.

## **NEW ACCOUNTING POLICIES**

As of January 1, 2007, The Company adopted the new Canadian Institute of Chartered Accountants standards for Accounting Changes, Comprehensive Income, Equity, Financial Instruments - Recognition and Measurement, Financial Instruments - Disclosure and Presentation and Hedges.

These new accounting standards address primarily the recognition and measurement of financial assets, financial liabilities and non-financial derivatives. Financial instruments are classified into one of four categories, each category determines how an instrument is measured and when and where gains and losses are recognized. Instruments are either measured at fair value or amortized cost, which is determined using the effective interest method. The Hedging standard provides guidance on when and how hedge accounting may be performed and the Comprehensive Income standard provides standards on the reporting and display of comprehensive income and its components.

These standards have been applied by the Company, on a prospective basis, in accordance with the relevant transitional provisions.

## **FUTURE ACCOUNTING POLICIES**

The Company has assessed the recently issued and revised accounting pronouncements and determined that the following may have an impact on the Company:

- i. As of January 1, 2008, the Company will be required to adopt CICA Handbook Sections 3862, Financial Instruments – Disclosures; 3863, Financial Instruments – Presentation; 1535, Capital Disclosures and 1400, General Standards of Financial Statement Presentation. The Company is assessing the impact of these new standards on its financial statements and anticipates the main impact will be in terms of additional disclosures required.
- ii. As of January 1, 2009, the Company will be required to adopt CICA Handbook Section 3064 Goodwill and Intangible Assets which replaces CICA Handbook Sections 3062 Goodwill and Other Intangible Assets and Section 3450 Research and Development Costs. The Company is assessing the impact of this new standard on its financial statements; however, the adoption is not expected to have a material impact on its financial statements.

The Accounting Standards Board of the Canadian Institute of Chartered Accountants has recently confirmed that in the year 2011 International Financial Reporting Standards ("IFRS") will replace current GAAP for publically accountable profit-oriented enterprises in Canada. The official changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. Companies will be required to provide comparative IFRS information for the previous fiscal year. At present the Company is actively monitoring and assessing the impact of convergence of Canadian GAAP and IFRS.

## **ADVISORIES**

### **Disclosure Controls and Procedures**

Disclosure controls and procedures have been designed to provide reasonable assurance 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 Executive Officer and Chief Financial Officer have concluded, based on their assessment, that the disclosure controls and procedures in place are effective to provide reasonable assurance that material information related to Richards Oil & Gas Limited is made known to them. It should be noted that while the Company's Chief Executive Officer and Chief Financial Officer believe that the Company's disclosure controls and procedures are effective, except for the material weaknesses in design of the internal controls noted below, they do not expect that the disclosure controls and procedures will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable assurance, not absolute assurance, that the objectives of the control system are met.

### **Internal Controls over Financial Reporting**

The Chief Executive Officer and Chief Financial Officer of Richards Oil & Gas Limited are responsible for designing internal controls over financial reporting or causing them to be designed under their supervision in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. Management has identified certain weaknesses that it considers necessary to disclose in order to present an accurate and complete picture of the condition of the design of the Company's internal controls over financial reporting as required by Canadian Securities Administrators' Notice 52-316.

- i. The Company is not able to achieve appropriate segregation of incompatible accounting duties, with its current accounting staff complement.
- ii. The Company does not have a sufficient number of financial accounting personnel with the technical accounting knowledge to address all complex and non-routine accounting transactions that may arise.

Management and the board of directors work to mitigate the risk of a material misstatement in financial reporting, through the review of financial accounting processes, financial disclosures and communication with the external auditors. The Company does not believe that the additional costs to hire additional personnel to mitigate these weaknesses are justifiable at this stage in the Company's development.

### **BOE Presentation**

Throughout this MD&A BOE, or barrel of oil equivalent, is defined as 6 Mcf to 1 bbl. BOEs may be misleading particularly if used in isolation. A BOE conversion ratio of 6 Mcf:1 bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

### **Non-GAAP Measures**

The Company's management uses and reports certain non-GAAP measures in the evaluation of operating and financial performance. These measures do not have any standardized meanings prescribed by Canadian GAAP and therefore may not be comparable with the calculation of similar measures for other companies.

The Company uses the term Operating Netbacks to evaluate operational performance of the Company. Operating netback, which is calculated as average unit sales price less royalties, and operating expenses, represents the operating cash margin for every barrel oil equivalent sold. Readers should refer to the "OPERATING NETBACKS" section of the MD&A for the calculations of operating netbacks.

## MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The accompanying financial statements are the responsibility of management. The financial statements have been prepared by management in accordance with the accounting policies outlined in the notes to the financial statements. Financial statements include certain amounts based on estimates and judgments. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly, in all material respects. In the opinion of management, the financial statements have been prepared within acceptable limits of materiality and are in accordance with Canadian generally accepted accounting principles. The financial information contained in the annual report is consistent with that in the financial statements.

Management maintains appropriate systems of internal control. Policies and procedures are designed to give reasonable assurance that transactions are appropriately authorized, assets are safeguarded and financial records are properly maintained to provide reliable information for the preparation of financial statements.

KPMG LLP, an independent firm of chartered accountants, was appointed by a vote of shareholders at the Company's last annual meeting to audit the financial statements and provide an independent opinion.

The audit committee of the Board of Directors has reviewed the financial statements including notes thereto, with management and KPMG LLP. The financial statements have been approved by the Board of Directors on the recommendation of the audit committee.



**Brad Turner**  
President and Chief Executive Officer  
April 14, 2008



**Lonnie Bate**  
Chief Financial Officer

## AUDITORS' REPORT

To the Shareholders of Richards Oil & Gas Limited

We have audited the balance sheets of Richards Oil & Gas Limited as at December 31, 2007 and 2006 and the statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

**KPMG LLP**

KPMG LLP  
Chartered Accountants  
April 14, 2008

**RICHARDS OIL & GAS LIMITED**  
BALANCE SHEETS

As at December 31,	2007	2006
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash and cash equivalents	\$ 6,225,567	\$ 8,117,678
Accounts receivable	2,571,115	987,143
Prepaid expenses	103,546	50,975
	<u>8,900,228</u>	<u>9,155,796</u>
PROPERTY AND EQUIPMENT (note 4)	16,064,757	21,283,331
DEFERRED FINANCING CHARGES	-	566,563
	<u>\$ 24,964,985</u>	<u>\$ 31,005,690</u>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Accounts payable and accrued liabilities	\$ 4,794,023	\$ 3,146,831
CONVERTIBLE DEBENTURES (note 5)	5,050,722	5,212,873
ASSET RETIREMENT OBLIGATION (note 6)	736,956	564,548
FUTURE INCOME TAXES (note 11)	-	1,348,466
	<u>10,581,701</u>	<u>10,272,718</u>
<b>SHAREHOLDERS' EQUITY</b>		
SHARE CAPITAL (note 7)	28,804,906	21,712,192
WARRANTS (note 7)	1,588,081	783,005
EQUITY COMPONENT OF CONVERTIBLE DEBENTURES (note 5)	1,435,822	1,435,822
CONTRIBUTED SURPLUS (note 9)	3,502,156	2,192,993
DEFICIT	<u>(20,947,681)</u>	<u>(5,391,040)</u>
	<u>14,383,284</u>	<u>20,732,972</u>
	<u>\$ 24,964,985</u>	<u>\$ 31,005,690</u>

COMMITMENTS (note 14)

*The accompanying notes form an integral part of these financial statements.*

**APPROVED BY THE BOARD OF DIRECTORS**



**Brian Moss, Chairman of the Board of Directors**



**Lyell Farquharson, Director**

**RICHARDS OIL & GAS LIMITED**  
**STATEMENTS OF OPERATIONS AND DEFICIT**

For the years ended December 31,	2007	2006
<b>REVENUE</b>		
Production	\$ 2,102,333	\$ 1,217,674
Royalties (net of Alberta royalty tax credit)	(392,611)	(230,186)
Interest and other	293,646	156,561
	<u>2,003,368</u>	<u>1,144,049</u>
<b>EXPENSES</b>		
Operating	1,000,946	638,651
General and administrative	1,924,035	2,300,931
Stock-based compensation	453,683	1,239,607
Interest and financing charges (note 12)	1,074,483	590,150
Depletion, amortization and accretion	1,463,245	792,695
Impairment of oil and gas properties (note 4)	14,100,000	1,725,000
	<u>20,016,392</u>	<u>7,287,034</u>
NET LOSS, before income taxes	(18,013,024)	(6,142,985)
Future income tax reduction (note 11)	2,456,383	1,994,933
NET LOSS	(15,556,641)	(4,148,052)
DEFICIT, beginning of year	(5,391,040)	(1,242,988)
DEFICIT, end of year	<u>\$ (20,947,681)</u>	<u>\$ (5,391,040)</u>
Loss per share (note 8)	\$ (0.29)	\$ (0.12)

*The accompanying notes form an integral part of these financial statements.*

**RICHARDS OIL & GAS LIMITED**  
**STATEMENTS OF CASH FLOWS**

For the years ended December 31,	2007	2006
<b>CASH FLOW FROM OPERATING ACTIVITIES</b>		
Net loss for the year	\$ (15,556,641)	\$ (4,148,052)
Items not affecting cash		
Stock-based compensation	453,683	1,239,607
Depletion, amortization and accretion	1,463,245	792,695
Impairment of oil and gas properties	14,100,000	1,725,000
Accretion of discount on convertible debentures	404,412	214,023
General and administrative costs settled with the issuance of shares	-	292,000
Interest expense settled with the issuance of shares	-	269,261
Future income tax reduction	(2,456,383)	(1,994,933)
Asset retirement expenditures	(195,454)	(27,427)
Net change in non-cash working capital (note 13)	(39,841)	72,076
	<u>(1,826,979)</u>	<u>(1,565,750)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Additions of property and equipment	(9,761,919)	(14,416,551)
Change in non-cash working capital (note 13)	50,490	(672,998)
	<u>(9,711,429)</u>	<u>(15,089,549)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issuance of share capital (net of costs)	9,646,297	6,465,919
Issuance of convertible debentures	-	6,500,000
Deferred financing charges	-	(586,240)
	<u>9,646,297</u>	<u>12,379,679</u>
<b>DECREASE IN CASH and CASH EQUIVALENTS</b>	<b>(1,892,111)</b>	<b>(4,275,620)</b>
<b>CASH and CASH EQUIVALENTS, BEGINNING of YEAR</b>	<b>8,117,678</b>	<b>12,393,298</b>
<b>CASH and CASH EQUIVALENTS, END of YEAR</b>	<b>\$ 6,225,567</b>	<b>\$ 8,117,678</b>

*The accompanying notes form an integral part of these financial statements*

# **RICHARDS OIL & GAS LIMITED**

## **NOTES TO THE FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

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### **1. DESCRIPTION OF BUSINESS**

Richards Oil & Gas Limited (the "Company") was incorporated under the Business Corporations Act (Alberta) on May 18, 2004. Richards Oil & Gas Limited is an oil and gas exploration company that specializes in the exploration, development and exploitation of coalbed methane properties. The Company has conventional oil and gas production in the provinces of Alberta and Saskatchewan and is actively exploring for, developing and producing from coalbed methane properties in Alberta.

### **2. SIGNIFICANT ACCOUNTING POLICIES**

#### **Basis of Presentation**

The financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions regarding certain assets, liabilities, revenues and expenses. Such estimates must often be made based on unsettled transactions and other events and a precise determination of many assets and liabilities is dependent upon future events. Actual results may differ from estimated amounts.

#### **Joint Operations**

Substantially all of the Company's operations are conducted jointly with others, and accordingly, the financial statements reflect only the Company's interest in such activities.

#### **Cash and Cash Equivalents**

Cash includes cash and short-term money market instruments with a maturity of less than three months.

#### **Property and Equipment**

The Company follows the full cost method of accounting for its oil and gas properties, whereby all costs associated with the exploration for and development of oil and gas reserves, whether productive or unproductive, are capitalized. Costs include land acquisitions, drilling, well equipment, geological and geophysical, administrative and stock-based compensation expenses related to exploration and development activities. Gains or losses are not recognized upon disposition of oil and gas properties unless crediting the proceeds against accumulated costs would result in a change in the rate of depletion of 20% or more.

The accumulated costs, less the costs of unproved properties, are depleted and depreciated using the unit-of-production method based on total proved reserves before royalties as determined by independent reserves evaluators. For purposes of the depletion and depreciation calculations, oil and gas reserves are converted to a common unit of measure on the basis of their relative energy content.

The costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of impairment is added to the costs subject to depletion.

Net capitalized costs of the Company's oil and gas properties are subject to a ceiling test to ensure that capitalized costs do not exceed an estimate of future net revenues. This latter amount is the aggregate of expected undiscounted future net cash flows from proved reserves and costs of unproven properties. Future cash flows are estimated using expected future prices and costs. If the carrying amount is assessed to be not fully recoverable, the cost centre is written down to its fair value estimated as the present value of expected future cash flows, using forecast prices, from proved and probable reserves and the value of unproved properties. The impairment in the carrying amount would be recognized and charged to current operations as additional depletion.

# **RICHARDS OIL & GAS LIMITED**

## **NOTES TO THE FINANCIAL STATEMENTS**

**FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006**

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### **Asset Retirement Obligation**

The fair value of the estimated asset retirement obligation is recognized in the balance sheet when incurred and a reasonable estimate of fair value can be made. Asset retirement obligations include those legal obligations where the Company will be required to retire long-lived assets such as producing well sites and processing facilities. The asset retirement cost, equal to the initially estimated fair value of the asset retirement obligation, is capitalized as part of the cost of the related long lived asset. Changes in the estimated obligation resulting from revisions to estimated timing or amount of undiscounted cash flows are recognized as a change in the asset retirement obligation and the related asset retirement cost.

Asset retirement costs for crude oil and natural gas assets are amortized using the unit-of-production method. Amortization of asset retirement costs is included in depletion, amortization and accretion expense. Increases in the asset retirement obligation resulting from the passage of time are recorded as accretion expense.

### **Convertible Debentures**

Convertible debentures have been classified as debt, net of the fair value of the conversion feature at the date of issue, which is recorded as equity component of convertible debentures and classified as a part of shareholders' equity. Issue costs associated with the placement of the convertible debentures reduce the liability component of the convertible debenture balance. The debt portion of the convertible debentures, net of the conversion feature and the issue costs, is accreted up to its face value over its term using the effective interest rate method. The accretion to the convertible debentures and the interest paid are included in interest and financing charges. When convertible debentures are converted into common shares of the Company, that portion of the value of the conversion feature within shareholders' equity will be reclassified to common shares along with the principal amount converted.

### **Future Income Taxes**

The Company follows the liability method of accounting for income taxes. Under this method, income tax liabilities and assets are recognized for the estimated tax consequences attributable to differences between the amounts reported in the financial statements and their respective tax basis, using enacted or substantially enacted tax rates. The effect of changes in income tax rates on future income tax liabilities and assets is recognized in income for the period in which the change occurs.

### **Revenue Recognition**

Revenue is recognized when goods have been delivered, when services have been performed, or when hydrocarbons have been produced and delivered and payment is reasonably assured.

### **Stock-Based Compensation**

The Company follows the fair value method of valuing stock options. Under this method, compensation cost, attributable to stock options granted and issued to employees, contractors, officers and directors of the Company are measured at fair value at the date of grant and either capitalized or expensed over the vesting period with a corresponding increase to contributed surplus. Capitalized amounts are charged to earnings as depletion over the life of estimated reserves. When stock options are exercised for common shares, consideration paid by the stock option holders and contributed surplus associated with the stock options are recorded as share capital.

### **Financial Instruments**

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities and convertible debentures. The fair value of the convertible debentures approximates the carrying amount of the convertible debentures. The fair values of the other financial instruments approximate their carrying amounts due to the short-term maturity of these instruments. The Company is exposed to credit risk on its accounts receivable from its customers. The Company believes there is no significant concentration of credit risk.

**RICHARDS OIL & GAS LIMITED**  
NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

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**Share Purchase Warrants**

The Company estimates the fair value of share purchase warrants when the share purchase warrants are issued. Fair value is estimated using the Black-Scholes option-pricing model. When exercised, the fair value is added to share capital to represent the cost to the Company of issuing the warrants.

**Flow-Through Shares**

The Company has financed a portion of its exploration activities through the issuance of flow-through shares. Under the terms of the flow-through share issues, the tax attributes of the related expenditures are renounced to subscribers when the flow-through shares are issued. To recognize the foregone tax benefits to the Company, share capital is reduced and future income taxes are increased in the period when the Company files the renouncement with the appropriate tax authorities.

**Per Share Amounts**

Basic earnings per share is calculated by dividing earnings by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflect the potential dilution that could occur if stock options, warrants and convertible debentures were converted or exercised. The treasury stock method is used to determine the dilutive effect of these dilutive securities. Under the treasury stock method, only proceeds received from the exercise of "in the money" stock options, warrants and convertible debentures are used to determine the impact on the diluted per share calculations.

**Use of Estimates**

The amounts recorded for depletion and amortization of property and equipment, stock-based compensation, share purchase warrants, income taxes and the asset retirement obligation, are based on estimates. The ceiling test is based on estimates of oil and natural gas reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates and those related to future cash flows used to assess impairment are subject to change and the impact on future financial statements resulting from changes in such estimates could be significant.

**3. CHANGES IN ACCOUNTING POLICIES AND PRACTICES**

**Financial Instruments**

As of January 1, 2007, The Company adopted the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 1506 "Accounting Changes"; Section 1530 "Comprehensive Income"; Section 3251 "Equity"; Section 3855 "Financial Instruments - Recognition and Measurement"; Section 3861, "Financial Instruments - Disclosure and Presentation" and Section 3865 "Hedges." These standards have been applied prospectively and accordingly the prior period financial statements have not been restated.

CICA Section 1506, "Accounting Changes," provides expanded disclosures for changes in accounting policies, accounting estimates and corrections of errors. Under the new standard, accounting changes should be applied retrospectively unless otherwise permitted or where impracticable to determine. As well, voluntary changes in accounting policy are made only when required by the accounting standards or the change results in more relevant and reliable information. The standard also requires that when a company has not adopted a new accounting standard that has been issued but not yet effective, the company shall disclose (a) this fact; and (b) known or reasonably estimable information relevant to assessing the possible impact that application of the new standard will have on the company's financial statements in the period of initial application. There are currently two new Canadian accounting standards that have been issued which will require additional disclosure in the Company's financial statements on January 1, 2008 about the Company's financial instruments as well as its capital and how it is managed.

CICA Section 1530, "Comprehensive Income", introduces a new requirement to temporarily present certain gains and losses from changes in fair values outside net income. It includes unrealized gains and losses, such as: changes in the currency translation adjustment relating to self-sustaining foreign operations; unrealized gains or losses on available-for-sale investments; and the effective portion of gains or losses on derivatives designated as cash flow hedges. The application of this standard did not result in

**RICHARDS OIL & GAS LIMITED**  
NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

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comprehensive income (loss) being different from the Company's net loss for the periods presented.

CICA Section 3251, "Equity", introduces new standards for the presentation of equity and changes in equity during the reporting period. Application of the section did not result in changes to the presentation of the Company's shareholders' equity.

CICA Section 3855, "Financial Instruments - Recognition and Measurement", prescribes when a financial instrument is to be recognized on the balance sheet and at what amount. It also specifies how financial instrument gains and losses are to be presented. All financial instruments are classified into one of the following five categories: held for trading, held-to-maturity, loans and receivables, available-for-sale financial assets, or other financial liabilities. Initial and subsequent measurement and recognition of changes in the value of financial instruments depends on their initial classification:

- i) Held-to-maturity investments, loans and receivables, and other financial liabilities are initially measured at fair value and subsequently measured at amortized cost using the effective interest rate method. Transaction costs are included in the recognized amount of the related financial instrument. The amortization of transaction costs, premiums or discounts and losses due to impairment are included in current period net earnings.
- ii) Available-for-sale financial assets are measured at fair value. Gains and losses are included in other comprehensive income until the asset is either disposed of or impaired.
- iii) Held for trading financial instruments, which includes derivatives, are measured at fair value. All gains and losses are included in net earnings in the period in which they arise unless they relate to certain hedging relationships.

As a result of the application of CICA Section 3855 the Company has reclassified \$566,563 of deferred financing costs as at January 1, 2007 associated with its convertible debentures against the carrying value of the liability portion of the convertible debentures. The impact of amortizing transaction costs using the effective interest rate method opposed to the straight line method used in the prior year was not significant.

CICA Section 3861, "Financial Instruments - Disclosure and Presentation", addresses new standards for the presentation of financial instruments and non-financial derivatives, and identifies the information that should be disclosed about them. Application of the section did not result in changes to the presentation of this section did not significantly impact the financial statements.

CICA Section 3865, "Hedges", specifies how hedge accounting is applied and what disclosures are necessary when it is applied. The Company does not currently apply hedge accounting.

**Future Accounting Policies**

The Company has assessed the recently issued and revised accounting pronouncements and determined that the following may have an impact on the Company:

- i) As of January 1, 2008, the Company will be required to adopt CICA Handbook Sections 3862, Financial Instruments – Disclosures; 3863, Financial Instruments – Presentation; 1535, Capital Disclosures and 1400, General Standards of Financial Statement Presentation. The Company is assessing the impact of these new standards on its financial statements and anticipates the main impact will be in terms of additional disclosures required.
- ii) As of January 1, 2009, the Company will be required to adopt CICA Handbook Section 3064 Goodwill and Intangible Assets which replaces CICA Handbook Sections 3062 Goodwill and Other Intangible Assets and Section 3450 Research and Development Costs. The Company is assessing the impact of

**RICHARDS OIL & GAS LIMITED**  
NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

this new standard on its financial statements; however, the adoption is not expected to have a material impact on its financial statements.

The Accounting Standards Board of the Canadian Institute of Chartered Accountants has recently confirmed that in the year 2011 International Financial Reporting Standards ("IFRS") will replace current GAAP for publically accountable profit-oriented enterprises in Canada. The official changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. Companies will be required to provide comparative IFRS information for the previous fiscal year. At present the Company is actively monitoring and assessing the impact of convergence of Canadian GAAP and IFRS.

**4. PROPERTY AND EQUIPMENT**

\$ Amount	As at December 31, 2007	As at December 31, 2006
Capitalized costs – oil and natural gas properties	34,187,334	23,903,407
Capitalized costs – other assets	105,095	93,726
Accumulated depletion and amortization	(18,227,672)	(2,713,802)
<b>Net book value</b>	<b>16,064,757</b>	<b>21,283,331</b>

As at December 31, 2007, unproved property costs of \$4,883,891 (December 31, 2006 – \$5,153,971) were excluded from costs subject to depletion. At December 31, 2007, \$12,281,500 (December 31, 2006 - \$8,922,000) of future development costs were included in the costs subject to depletion. The Company capitalizes the salaries of those employees directly involved in exploration activities. For the year ended December 31, 2007, the Company capitalized \$270,036 of salaries and \$214,890 of stock-based compensation related to exploration staff.

The Company performed a ceiling test calculation at December 31, 2007 resulting in undiscounted cash flows from proved reserves not exceeding the carrying value of oil and gas assets. Consequently, the Company performed stage two of the ceiling test assessing whether discounted future cash flows from the production of proved plus probable reserves exceeded the carrying value of its oil and natural gas properties. As a result of performing this test, a ceiling test impairment loss of \$8,250,000 has been recorded as an impairment of oil and natural gas properties in the statements of operations and deficit and is included in accumulated depletion. This impairment is in addition to the \$5,850,000 in impairment losses recorded in prior quarters for the year ended December 31, 2007. Total impairment losses amounted to \$14,100,000 for the year ended December 31, 2007. The prices used in the ceiling test evaluation of the Company's oil and natural gas reserves at December 31, 2007 were:

Forecast Year	WTI Crude Oil (\$US/Barrel)	Edmonton par Price 40° API (\$CAD/Barrel)	Alberta AECO-C Spot (\$CAD/MMBtu)	Inflation Rate (%)	Exchange Rate (\$US/\$CAD)
2008	89.61	88.17	6.51	2.0	1.000
2009	86.01	84.54	7.22	2.0	1.000
2010	84.65	83.16	7.69	2.0	1.000
2011	82.77	81.26	7.70	2.0	1.000
2012	82.26	80.73	7.61	2.0	1.000

*Various Escalation Rates Thereafter*

**RICHARDS OIL & GAS LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

**5. CONVERTIBLE DEBENTURES**

On June 26, 2006 the Company issued \$6.5 million of 8.0% convertible unsecured subordinated debentures (the "Convertible Debentures") for net proceeds of \$5.9 million. The Convertible Debentures have an initial maturity date of June 26, 2011. The Convertible Debentures bear interest at 8.0% per annum which is paid semi-annually on June 30 and December 31 of each year and are subordinated to all other liabilities of the Company.

The Convertible Debentures are convertible at the option of the holder into common shares of the Company at any time after October 26, 2006 and prior to June 26, 2008 at a conversion price of \$1.65 per share. From June 26, 2008 until maturity, the conversion price increases by 10% per year. The Convertible Debentures are not redeemable by the Company before June 28, 2008 but may be redeemed in whole or in part at the option of the Company providing the Company's common shares are trading at not less than \$3.50 per share for 20 consecutive trading days ending five days prior to conversion. Redemptions and conversions entitle the holder to accrued and unpaid interest to and including the effective date.

At the option of the Company, the payment of interest and the repayment of the principal amount of the Convertible Debentures may be settled in common shares. The number of common shares to be issued upon redemption by the Company will be calculated by dividing the interest or principal by 95% of the weighted average trading price for 20 consecutive trading days ending five days prior to the date the obligation is due.

The following summarizes the Company's accounting for its Convertible Debentures:

\$ Amount	Equity Component	Liability Component
Initial balance at June 26, 2006	1,435,822	5,064,178
Accretion of non-cash interest expense	-	148,695
<b>Balance as at December 31, 2006</b>	<b>1,435,822</b>	<b>5,212,873</b>
Issue costs reclassified to carrying amount on change in accounting policy on January 1, 2007	-	(566,563)
Accretion of non-cash interest expense	-	404,412
<b>Balance as at December 31, 2007</b>	<b>1,435,822</b>	<b>5,050,722</b>

**6. ASSET RETIREMENT OBLIGATION**

As at December 31, 2007 the Company has estimated undiscounted future costs related to the abandonment and restoration of its oil and gas properties to be \$1,155,194 (December 31, 2006 - \$814,404). These obligations are to be settled over an average of 6.7 years and have been discounted using a credit-adjusted risk free interest rate of 7.3% and inflation rate of 2.0%.

Changes to the asset retirement obligation were as follows:

\$ Amount	2007	2006
Balance, beginning of year	564,548	328,569
Liabilities incurred during the year	318,487	232,971
Liabilities settled during the year	(195,454)	(27,427)
Accretion of asset retirement obligation during the year	49,375	30,435
<b>Balance, end of year</b>	<b>736,956</b>	<b>564,548</b>

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**7. SHARE CAPITAL**

Authorized:

-Unlimited number of common voting shares

*i) Changes in Common Share Capital*

	Number	\$ Amount
<b>Balance as at December 31, 2005</b>	<b>32,679,499</b>	<b>17,664,529</b>
Flow-through shares issued	4,000,000	4,000,000
Share issuance costs (net of future tax of \$114,036)	-	(343,919)
Issued as consideration for general and administrative costs	200,000	292,000
Issued as consideration for interest expense	273,025	269,261
Warrants exercised	3,811,837	3,742,024
Stock options exercised	27,603	14,577
Tax effect of flow-through share renouncements	-	(3,926,280)
<b>Balance as at December 31, 2006</b>	<b>40,991,964</b>	<b>21,712,192</b>
Shares issued	31,250,000	8,411,919
Share issuance costs (net of future tax of \$178,490)	-	(402,532)
Warrants exercised for cash	419,638	227,319
Transfer from warrants account on exercise	-	80,008
Tax effect of flow-through share renouncements	-	(1,224,000)
<b>Balance as at December 31, 2007</b>	<b>72,661,602</b>	<b>28,804,906</b>

*ii) Stock Options*

On October 2, 2004 the Company adopted a stock option plan whereby options may be granted from time to time to directors, officers, employees, and consultants to the Company. Under the terms of the original stock option plan common shares to be reserved for issuance as stock options are not to exceed 10% of the common shares outstanding and no one individual is allowed to hold stock options that if exercised would entitle the holder to acquire more than 5% of the outstanding common shares of the Company in any one year period. One third of the stock options issued under the original stock option plan vested immediately and one third on each of the first and second anniversary dates of the grant. On June 29, 2006 the vesting provisions of the original stock option plan were amended. Under the amended stock option plan all grants, except those issued to consultants to the Company, will vest one half of the stock options issued immediately and the remaining half on the first anniversary date of the grant. All stock options granted by the Company have a five year term.

The fair value of the stock options granted during the year ended December 31, 2007 have been determined using the Black-Scholes option-pricing model using the following assumptions; dividend yield (nil), expected volatility (73-79%), market risk-free interest rate (3.98-4.28%), and expected life of 5 years. The fair value of the stock options is recorded as stock-based compensation with an offsetting credit to contributed surplus over the vesting period. For the year ended December 31, 2007 the fair value of the options granted was \$470,892 (2006 - \$1,064,326).

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The number of stock options granted and their exercise prices are as follows:

	Year ended December 31, 2007		Year ended December 31, 2006	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at beginning of year	3,706,970	\$ 1.32	2,627,937	\$ 1.08
Options granted	2,155,000	\$ 0.34	1,301,970	\$ 1.71
Options exercised	-	\$ -	(27,603)	\$ (0.40)
Options expired	(658,637)	\$ 1.33	(12,000)	\$ (0.40)
Options forfeited	-	\$ -	(183,334)	\$ (0.89)
<b>Outstanding at end of year</b>	<b>5,203,333</b>	<b>\$ 0.91</b>	<b>3,706,970</b>	<b>\$ 1.32</b>
<b>Exercisable at end of year</b>	<b>4,179,998</b>	<b>\$ 1.05</b>	<b>3,178,637</b>	<b>\$ 1.23</b>

The December 31, 2007 outstanding balances above include 280,000 agent stock options relating to the placement of the December 29, 2006 flow through share offering. These agent stock options vested immediately at time of grant

The following summarizes details about the Company's stock option granted as at December 31, 2007:

Range of exercise price	Options outstanding				Options vested	
	Outstanding options	Remaining contract life	Weighted average exercise price	Vested options	Remaining contract life	Weighted average exercise price
\$0.24 to \$0.49	2,030,000	4.25	\$0.27	1,219,166	3.94	\$0.29
\$0.50 to \$0.99	1,033,333	3.30	\$0.77	824,166	3.05	\$0.79
\$1.00 to \$1.49	1,180,000	2.36	\$1.33	1,180,000	2.37	\$1.33
\$1.50 to \$1.99	510,000	3.17	\$1.71	506,666	3.17	\$1.71
\$2.00 to \$2.49	450,000	3.25	\$2.14	450,000	3.25	\$2.14
	<b>5,203,333</b>	<b>3.44</b>	<b>\$0.91</b>	<b>4,179,998</b>	<b>3.15</b>	<b>\$1.05</b>

*iii) Warrants*

The following table summarizes all warrants outstanding as at December 31, 2007:

Balance as at December 31, 2006	Warrant type	Issued	Expire	Exercise price \$	Warrants Issued / (Expired)	Warrants Exercised	Balance as at December 31, 2007
258,533	Shareholder	May 12, 2005	May 12, 2007	0.50	(82,405)	(176,128)	-
327,293	Agent	June 20, 2005	June 20, 2007	0.50	(153,783)	(173,510)	-
1,483,116	Shareholder	Oct. 7, 2005	April 7, 2007	1.25	(1,483,116)	-	-
514,913	Agent	Oct. 7, 2005	April 7, 2007	0.90	(514,913)	-	-
538,738	Agent	Oct. 7, 2005	April 7, 2007	0.75	(468,738)	(70,000)	-
404,617	Shareholder	Oct. 21, 2005	April 21, 2007	1.25	(404,617)	-	-
26,651	Agent	Oct. 21, 2005	April 21, 2007	0.90	(26,651)	-	-
101,503	Agent	Oct. 21, 2005	April 21, 2007	0.75	(101,503)	-	-
-	Shareholder	July 10, 2007	July 10, 2009	0.40	15,625,007	-	15,625,007
<b>3,655,364</b>					<b>12,389,281</b>	<b>(419,638)</b>	<b>15,625,007</b>

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When share purchase warrants are exercised the consideration received by the Company is recorded in the share capital account along with the fair value of the warrants previously recognized in the warrants account. The following table summarizes the changes in the warrants account:

\$ Amount	Year ended December 31, 2007	Year ended December 31, 2006
Balance, beginning of year	783,005	1,703,710
Fair value of warrants issued	1,588,081	-
Warrants exercised into common voting shares	(80,008)	(920,705)
Transfer of expired warrants to contributed surplus account	(702,997)	-
<b>Balance, end of year</b>	<b>1,588,081</b>	<b>783,005</b>

**8. LOSS PER SHARE AMOUNTS**

Per share amounts have been calculated based on the weighted average number of shares outstanding. Basic and diluted loss per share for both is calculated as follows:

	Net Loss	Weighted average number of shares	Loss per share
Year ended: December 31, 2007	\$ (15,556,641)	53,540,137	\$ (0.29)
December 31, 2006	\$ (4,148,052)	34,594,196	\$ (0.12)

For the years ended December 31, 2007 and December 31, 2006 the conversion of stock options, convertible debentures and warrants is anti-dilutive.

**9. CONTRIBUTED SURPLUS**

The following table summarizes the changes in the Company's contributed surplus account:

\$ Amount	Year ended December 31, 2007	Year ended December 31, 2006
Balance, beginning of year	2,192,993	491,457
Stock-based compensation	606,166	1,567,907
Transfer of expired warrants from warrants account	702,997	-
Exercise of stock options	-	(3,537)
Fair value of agent stock options granted	-	91,515
Fair value of agent options capitalized to deferred financing charges	-	45,651
<b>Balance, end of year</b>	<b>3,502,156</b>	<b>2,192,993</b>

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**10. RELATED PARTY TRANSACTIONS**

In 2006, the Company and an engineering and development consulting firm mutually agreed to restructure their relationship. The original services contract between the parties provided a 2% gross overriding royalty to the consulting firm on all lands introduced by them to the Company. Part of the consideration for the early termination of this services contract and the restructuring of the former relationship involved limiting the 2% gross overriding royalty payable to the consulting firm to specific oil and gas properties. Pursuant to a direction from the consulting firm, the Company was directed to pay this 2% gross overriding royalty to four corporations of which three were owned by existing or past officers of the Company. For the year ended December 31, 2007 payments to corporations controlled by two officers of the Company with respect to this 2% gross overriding royalty totaled \$9,389 (2006 - \$ 7,482). At December 31, 2007, \$4,271 (2006 - \$ 3,125) was owed to the same corporations controlled by two officers of the Company.

For the year ended December 31, 2007 payments to a corporation controlled by an officer of the Company with respect to the provision of consulting services totaled \$6,075. At December 31, 2007, \$6,075 was owed to the same corporation controlled by the officer of the Company.

**11. INCOME TAXES**

The provision for current and future income taxes differs from the result which would be obtained by applying the combined federal and provincial statutory tax rates to net loss before income taxes. This difference results from the following:

\$ Amount	Year ended December 31, 2007	Year ended December 31, 2006
Net loss, before income taxes	(18,013,024)	(6,142,985)
Statutory rates	32.60%	34.72%
Expected income tax provision (recovery) computed at statutory rates	(5,872,246)	(2,132,844)
Effect on income tax of:		
Non-deductible Crown royalties	-	11,902
Resource allowance	-	57,036
Stock-based compensation	147,901	430,449
Valuation allowance	2,189,953	-
Change in income tax rate and other	1,078,009	(361,476)
<u>Future income taxes</u>	<u>(2,456,383)</u>	<u>(1,994,933)</u>

As at December 31, 2007 the Company has non-capital loss carry-forwards of approximately \$13,385,000 (2006 - \$5,575,000) which expire in the years 2024 to 2027.

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Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts for income tax purposes. The components of the Company's future income tax assets and liabilities are as follows:

\$ Amount	As at December 31, 2007	As at December 31, 2006
Future income tax liabilities:		
Property and equipment	(1,730,306)	(3,404,445)
Future income tax assets:		
Asset retirement obligation	195,285	164,064
Share issue costs	407,415	444,110
Non-capital losses	3,317,559	1,447,805
Valuation allowance	(2,189,953)	-
<b>Future income tax (liability) asset</b>	<b>-</b>	<b>(1,348,466)</b>

**12. INTEREST AND FINANCING CHARGES**

The following table summarizes the components of interest and financing charges:

\$ Amount	Year ended December 31, 2007	Year ended December 31, 2006
Interest on convertible debenture	520,000	269,261
Accretion of discount on convertible debentures	404,412	214,023
Interest expense – Part XII.6 tax	150,071	106,866
<b>Total</b>	<b>1,074,483</b>	<b>590,150</b>

**13. SUPPLEMENTAL CASH FLOW INFORMATION**

Changes in non-cash working capital comprised the following:

\$ Amount	Year ended December 31, 2007	Year ended December 31, 2006
Accounts receivable	(1,583,972)	166,258
Prepaid expenses	(52,571)	(27,683)
Accounts payable and accrued liabilities	1,647,192	(739,497)
<b>Net change</b>	<b>10,649</b>	<b>(600,922)</b>
Net change by activity:		
Operating	(39,841)	72,076
Investing	50,490	(672,998)
<b>Net change</b>	<b>10,649</b>	<b>(600,922)</b>
<b>Cash interest paid on part XII.6 tax</b>	<b>121,607</b>	<b>17,374</b>

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**14. COMMITMENTS**

The Company is committed to payments under an operating lease for office space over the next five years. The operating lease commitment, before operating costs, for the next five years are as follows; 2008 - \$113,493, 2009 - \$136,192, 2010 - \$140,415, 2011 - \$144,638 and 2012 - \$148,860.

**15. CREDIT FACILITY**

The Company currently has in place a financing commitment with a Canadian chartered bank. The terms of the financing commitment provide the Company with a senior extendible credit facility with an initial borrowing base of \$1,500,000. Drawings on the credit facility bear interest at the bank's prime lending rate plus an applicable margin for Canadian dollar advances. A fixed and floating charge demand debenture on the assets of the Company has been provided as security. As at April 14, 2008 the Company has not made any drawings on the credit facility.