

## **Form 10QSB for DAYBREAK OIL & GAS INC**

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**21-Sep-2007**

### **Quarterly Report**

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Safe Harbor Provision**

The following Management's Discussion and Analysis ("MD&A") is management's assessment of the historical financial and operating results of Daybreak Oil and Gas, Inc. (referred to herein as "we", "our", the "Company" or "Daybreak") during the period covered by the financial statements. Certain statements in the MD&A report that are not historical in nature, including statements of management's expectations, intentions, plans and beliefs, are inherently uncertain and are "forward-looking statements" and are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements include those relating to estimated financial results, or expected prices, production volumes, reserve levels and number of drilling locations, expected drilling plans, including the timing, category, number, depth, cost and/or success of wells to be drilled, expected geologic formations or the availability of specific services or technologies. It is important to note that actual results may differ materially from the results predicted in any such forward-looking statements. Investors are cautioned that all forward looking statements involve risk and uncertainty. These risks and uncertainties include:

the costs and accidental risks inherent in exploring and developing new oil and natural gas reserves, the price for which such reserves and production can be sold, environmental concerns affecting the drilling of oil and natural gas wells, impairment of oil and gas properties due to depletion or other causes, the uncertainties inherent in estimating quantities of proved reserves and cash flows, as well as general market conditions, competition and pricing All statements other than statements of historical facts contained in this report, including statements regarding our current expectations and projections about future results, business strategy, performance, prospects and opportunities, are forward-looking statements. To understand about forward looking statements, please refer the section labeled forward looking statements. The following discussion should be read in conjunction with the unaudited financial statements and notes thereto included in this Form 10-QSB and with the Company's latest audited financial statements as reported in its Form 10-KSB for the year ended February 28, 2007.

### **Introduction**

The following discussion of our results of operations for the three month period ended May 31, 2007 (referred to herein as "the first quarter 2008") and 2006 (referred to herein as "the first quarter 2007") and of our financial condition as of May 31, 2007 should be read in conjunction with our financial statements and related notes thereto included elsewhere in this report.

### **Plan of Operation**

We are an early stage oil and gas exploration company with a limited operating history and minimal proven reserves, production or cash flow. To date, we have had limited revenues and have not been able to generate positive earnings. Daybreak cannot provide any assurances that it will ever operate profitably. As a result of our limited operating history, we are more susceptible to the numerous business risks, investment and industry risks that have been described in our most recent report on Form 10-KSB for our fiscal year ended February 28, 2007 (Item 1. Description of Business - "Risk Factors").

Our financial statements for the years ended February 28, 2007 and 2006 have been audited by our Independent Registered Public Accounting Firm. The Reports of Independent Registered Public Accounting Firm for each of these years include an explanatory paragraph stating that the financial statements have been prepared assuming the Company will continue as a going concern.

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The report also states that the Company has incurred significant operating losses that raise substantial doubt about its ability to continue as a going concern. The accompanying financial statements do not include any adjustments that might result from this uncertainty. If Daybreak cannot continue as a going concern, any equity investment in the Company could become devalued or worthless.

As an early stage energy company concentrating on oil and gas exploration and development; our expenditures consist primarily of geological and engineering services, acquiring mineral leases, exploration and drilling costs and travel. Our expenses also consist of consulting and professional services, compensation, legal and accounting and general and administrative expenses which we have incurred in order to address necessary organizational activities.

Our longer term success depends on, among many other factors, the acquisition and drilling of commercial grade oil and gas properties and the prevailing prices for oil and natural gas. Oil and natural gas prices have been extremely volatile in recent years and are affected by many factors outside our control. This volatile nature of the energy markets makes it difficult to estimate future prices of oil and natural gas; however, any prolonged period of depressed prices would have a material adverse effect on our results of operations and financial condition.

Our operations are focused on identifying and evaluating prospective oil and gas properties and funding projects that we believe have the potential to produce oil or gas in

commercial quantities. We are currently developing projects in Alabama, California, Louisiana and Texas. Since November of 2006, we have been involved as the operator of two project areas in Louisiana and in June of 2007, we became the operator of the Gilberttown project in Alabama. In the past we have relied on our working interest partners to negotiate all drilling, and sales contracts. Over the last two fiscal years, we have been involved in the drilling/workover and/or completion of thirteen (13) wells in Alabama, Louisiana, Texas and in Alberta, Canada. We have achieved or increased commercial production results in eight (8) of these wellbores.

## Liquidity and Capital Resources

Liquidity is defined as the ability to convert assets into cash or to obtain cash. Short-term liquidity refers to the ability to meet short-term obligations of 12 months or less.

Liquidity is a matter of degree and is expressed in terms of a ratio. Two common liquidity ratios in financial statement analysis are:

Working Capital and Current Ratio.

Working capital is defined as current assets minus current liabilities. Current ratio is defined as current assets divided by current liabilities.

	May 31, 2007	February 28, 2007
Current Assets	\$ 2,829,975	\$ 4,537,634
Current Liabilities	\$ 2,251,634	\$ 2,445,457
Working Capital	\$ 578,341	\$ 2,092,177
Current Ratio	1.26	1.86

While these two ratios are important, numerous other factors may also affect the liquidity and capital resources of the Company. Working capital declined from \$2.1 million as of February 28, 2007, to \$0.6 million as of May 31, 2007, a decrease of \$1.5 million. This decline was due primarily to losses incurred by the Company during the first quarter of the current fiscal year (\$618,000) coupled with a net increase in investments in oil and gas property (\$747,000), principally for the drilling and completion costs of the Haas-Hirsch No. 1 (now the KSU # 59) well in the Krotz Springs prospect.

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Our business is capital intensive. Our ability to grow is dependent upon our ability to obtain outside capital and generate cash flows from operating activities to fund our investment activities. At this time, we have not yet demonstrated the ability to generate significant and sustainable cash flow from producing wells developed as a result of our prior exploration and development activities. And, our independent registered auditors have expressed a substantial doubt regarding our ability to continue as a going concern.

Our only source of funds in the past has been through the debt or equity markets. Since we have not yet established profitable operations, this is also expected to be our source of

funds in the foreseeable future. Our business model is focused on acquiring developmental properties and also existing production. Our ability to generate future revenues and operating cash flow will depend on successful exploration, and/or acquisition of oil and gas producing properties, which will very likely require the Company to continue to raise equity or debt capital from sources outside of the Company.

The Company has ongoing capital commitments to develop certain leases pursuant to their underlying terms. Failure to meet such ongoing commitments may result in the loss of certain leases. These ongoing capital commitments may also cause the Company to seek additional capital from sources outside of the Company.

Since our future operations will continue to be heavily dependent on our ability to seek and secure capital from exterior sources, should we be unable to continue to find new capital from such sources, the Company may not be able to survive as a going concern, and any equity investment in the company could become worthless or substantially impaired in value.

Since our inception, we have suffered recurring losses from operations and negative cash flow and have depended on external financing to sustain our operations. During the fiscal year ("FY") ended February 28, 2007, we reported losses of \$8.4 million. Losses have continued into the 1st Quarter FY 2008, with the Company reporting a loss of \$617,660. Although this loss is less than the loss of \$2,460,847 reported in the 1st Quarter FY 2007, there is no assurance that the Company can ever achieve sustainable profitability. Failure to achieve sustainable profitability could prevent the Company from continuing as a going concern, and could cause any equity investment in the company to become worthless.

### **Critical Accounting Policies**

Management's discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period.

On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, bad debt, cancellations costs associated with long term commitments, investments, intangible assets, assets subject to disposal, income taxes, service contracts, contingencies and litigation.

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We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for

making estimates and judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Estimates, by their nature, are based on judgment and available information. Therefore, actual results could differ from those estimates and could have a material impact on our financial statements, and it is possible that such changes could occur in the near term.

### **Oil and Gas Properties**

We use the successful efforts method of accounting for oil and gas property acquisition, exploration, development, and production activities. Costs to acquire mineral interests in oil and gas properties, to drill and equip exploratory wells that find proved reserves, and to drill and equip development wells are capitalized as incurred. Costs to drill exploratory wells that are unsuccessful in finding proved reserves are expensed as incurred. In addition, the geological and geophysical costs, and costs of carrying and retaining unproved properties are expensed as incurred. Costs to operate and maintain wells and field equipment are expensed as incurred.

Capitalized proved property acquisition costs are amortized by field using the unit-of-production method based on proved reserves. Capitalized exploration well costs and development costs (plus estimated future dismantlement, surface restoration, and property abandonment costs, net of equipment salvage values) are amortized in a similar fashion (by field) based on their proved developed reserves. Support equipment and other property and equipment are depreciated over their estimated useful lives.

Pursuant to SFAS No. 144, "Impairment or Disposal of Long-Lived Assets", we review proved oil and natural gas properties and other long-lived assets for impairment. These reviews are predicated by events and circumstances, (such as downward revision of the reserve estimates or commodity prices), that indicate a decline in the recoverability of the carrying value of such properties. We estimate the future cash flows expected in connection with the properties and compare such future cash flows to the carrying amount of the properties to determine if the carrying amount is recoverable. When the carrying amounts of the properties exceed their estimated undiscounted future cash flows, the carrying amounts of the properties are reduced to their estimated fair value. The factors used to determine fair value include, but are not limited to, estimates of proved reserves, future commodity prices, the timing of future production, future capital expenditures and a risk-adjusted discount rate. The charge is included in depreciation, depletion and amortization.

Unproved oil and gas properties that are individually significant are also periodically assessed for impairment of value. An impairment loss for unproved oil and gas properties is recognized at the time of impairment by providing an impairment allowance.

On the retirement or sale of a partial unit of proved property, the cost is charged to accumulated depreciation, depletion, and amortization with a resulting gain or loss recognized in income.

Deposits and advances for services expected to be provided for exploration and development or for the acquisition of oil and gas properties are classified as long term other assets.

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### **Revenue Recognition**

We use the sales method to account for sales of crude oil and natural gas. Under this method, revenues are recognized based on actual volumes of oil and gas sold to purchasers. The volumes sold may differ from the volumes to which we are entitled based on its interests in the properties. These differences create imbalances which are recognized as a liability only when the imbalance exceeds the estimate of remaining reserves. We had no significant imbalances as of May 31, 2007 and February 28, 2007.

### **Suspended Well Costs**

On April 4, 2005, the Financial Accounting Standards Board, (FASB) issued FASB Staff Position No. 19-1, "Accounting for Suspended Well Costs" (FSP No. 19-1). This staff position amends SFAS No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies" and provides guidance concerning exploratory well costs for companies that use the successful efforts method of accounting. Daybreak adopted FSP No. 19-1 for the fiscal years ended February 28, 2007 and 2006.

The FSP states that exploratory well costs should continue to be capitalized if: (1) a sufficient quantity of reserves are discovered in the well to justify its completion as a producing well and (2) sufficient progress is made in assessing the reserves and the economic and operating feasibility of the well. If the exploratory well costs do not meet both of these criteria, these costs should be expensed, net of any salvage value. Additional annual disclosures are required to provide information about management's evaluation of capitalized exploratory well costs.

In addition, the FSP requires annual disclosure of: (1) net changes from period to period of capitalized exploratory well costs for wells that are pending the determination of proved reserves, (2) the amount of exploratory well costs that have been capitalized for a period greater than one year after the completion of drilling and (3) an aging of exploratory well costs suspended for greater than one year, designating the number of wells the aging is related to. Further, the disclosures should describe the activities undertaken to evaluate the reserves and the projects, the information still required to classify the associated reserves as proved and the estimated timing for completing the evaluation.

### **Share Based Payments**

Prior to February 28, 2005, we accounted for our stock based compensation plans under the recognition and measurement provisions of APB Opinion No. 25, "Accounting for

Stock Issued to Employees" and related Interpretations, ("APB 25") as permitted by SFAS No. 123, "Accounting for Stock Based Compensation" ("SFAS 123").

Effective March 1, 2005, we adopted the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") for our stock based compensation plans under the recognition and measurement provisions of SFAS 123. No awards granted prior to March 1, 2005 were modified or settled in cash during fiscal 2006.

Effective March 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123R, "Share Based Payment" and related Interpretations ("SFAS 123R").

Under both SFAS 123 and SFAS 123R, compensation cost for all share based payments granted on or subsequent to March 1, 2005 are based on the grant date fair value estimated in accordance with the provisions of SFAS 123 and SFAS 123R, for the respective fiscal years. Compensation cost is recognized on a straight line basis over the requisite service period for the entire award in accordance with the provisions of SFAS 123R. If at any date the portion of the grant-date fair value of the award that is vested is greater than that amount recognized on a straight line basis, the amount of the vested grant date fair value is recognized.

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We account for transactions in which we issue equity instruments to acquire goods or services from non-employees in accordance with the provisions of SFAS No. 123R (as amended). These transactions are accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable.

In addition, the financial statements included elsewhere herein, as well as the financial statements included in our most recent report on Form 10K-SB for the year ended February 28, 2007 were prepared as if the Company will continue as a going concern. An assumption otherwise may materially change the information included in the financial statements as well as the information included in the Management's discussion and analysis of our financial condition and results of operations

### **Three Months Ended May 31, 2007 Compared to the Three Months Ended May 31, 2006**

Revenues. Our revenues are derived entirely from the sale of our share of oil and gas production from our producing wells. The company realized its first revenues from producing wells in August 2006. Prior to that date, the Company had no revenues. Accordingly, 1st Quarter 2008 revenues of \$225,043 compares favorably to no revenues in the 1st Quarter 2007. During the 1st Quarter 2008, the company recorded revenues from its interest in 19 producing wells. While these results are encouraging, the Company continued to experience mechanical and technical production problems with certain

major wells, particularly the F-1 well of the Tuscaloosa Project in Tensas Parish, Louisiana. The F-1 well contributed no revenues in the 1st Quarter of 2008.

The F-1 well was shut in pending the resolution of certain mechanical problems in November, 2006. Production on this property was re-established for a short period of time in February, 2007. Afterward the F-1 well was shut in again pending resolution of certain gas sales and sales contract issues. The Company believes that these issues can be resolved and the production from this property can be re-established during the 3rd fiscal quarter of 2008. However, there is no assurance that these efforts will be successful.

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Cost and Expenses:

A table of the costs and expenses for the 1st quarter 2008 compared to the 1st quarter 2007 follows:

	Quarter Ended May 31, 2007	Quarter Ended May 31, 2006
Production Costs	\$ 109,847	\$ -
Exploration Costs	155,211	-
Depreciation, Depletion, Amortization	157,845	-
General & Administrative	390,103	2,147,619
Total Operating Expenses	\$ 813,006	\$ 2,147,619

Expenses incurred by the Company include production costs associated directly with the generation of oil and gas revenues, exploration and drilling costs related to the development of its oil and gas properties and general and administrative expenses, including legal and accounting expenses, management and director fees, investor relations expenses, and other general and administrative costs.

The increase in production costs to \$109,847 in the 1st quarter 2008, relates entirely to the existence of production from oil and gas operations.

Exploration and drilling expenses increased substantially from \$27,392 in the 1st quarter 2007 to \$155,211 in the 1st quarter 2008 due primarily to an increase in the number of wells in progress. The Company participated in the development of 6 wells during the 1st quarter 2008, compared to 1 well in the comparable period of the prior year.

The increase in depreciation, depletion, amortization and impairment to \$157,845 in the 1st quarter of 2008, relates entirely to the existence of production from oil and gas operations.

General and administrative expenses, including management and directors fees, investor relations fees and other general and administrative expenses were substantially lower in the 1st quarter 2008 compared to the 1st quarter 2007. Primarily, this is due to the

substantial stock compensation that was recorded in the 1st quarter 2007, for which there are no significant comparable amounts in the 1st quarter 2008.

Interest income was \$32,568 in the 1st quarter 2008 compared to \$0 in the 1st quarter 2007 due primarily to higher average cash and investment balances.

Interest expense decreased from \$313,228 in the 1st quarter 2007 to \$63,139 in the 1st quarter 2008 due to lower average debt balances as a result of conversions of debt to common stock.

Due to the nature of its business, as well as the relative immaturity of the business, the Company expects that revenues, as well as all categories of expenses, will continue to fluctuate substantially quarter to quarter and year to year. Production costs will fluctuate according to the number and percentage ownership of producing wells, as well as the amount of revenues being contributed by such wells. Exploration and drilling expenses will be dependant the amount of capital that the Company has to invest in future development projects, as well as the success or failure of such projects. Likewise, the amount of depreciation, depletion, amortization expense and impairment costs will depend upon the similar factors, as well as numerous other factors including general market conditions.

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### **Other Liquidity Factors**

The Company has convertible debentures in the amount of \$200,001 that, along within accrued interest, were originally due on August 31, 2007. On August 31, 2007, the maturity on these convertible debentures was extended to October 31, 2007. In addition, at May 31, 2007, the Company had a note payable to a related party in the amount of \$200,000 related to the pipeline used on the F-1 and F-3 wells. Since June 14, 2007, payments of \$170,000 have been made on the to reduce the balance of the note to \$30,000 plus accrued interest.

### **Summary**

Our ability to continue as a going concern depends in large part on our ability to raise substantial funds for use in our planned exploration and development activities, and upon the success of our fundraising activities.

We intend to obtain the funds for our planned exploration and development activities by various methods, which might include the issuance of equity or debt securities or obtaining joint venture partners. No assurance can be given that we will be able to obtain any additional financing on favorable terms, if at all.

Raising additional funds by issuing common or preferred stock will further dilute our existing stockholders.

## **Off-Balance Sheet Arrangements**

As of May 31, 2007, we did not have any relationships with unconsolidated entities or financial partners, such as entities often referred to as structured finance or special purpose entities, which have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

## **FORWARD-LOOKING STATEMENTS**

We believe that some statements contained in this Prospectus relate to results or developments that we anticipate will or may occur in the future and are not statements of historical fact. Words such as "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "plan," "predict," "project," "will" and similar expressions identify forward-looking statements. Examples of forward-looking statements include statements about the following:

- Our future operating results,
- Our future capital expenditures,
- Our expansion and growth of operations, and
- Our future investments in and acquisitions of oil and natural gas properties.

We have based these forward-looking statements on assumptions and analyses made in light of our experience and our perception of historical trends, current conditions, and expected future developments. However, you should be aware that these forward-looking statements are only our predictions and we cannot guarantee any such outcomes. Future events and actual results may differ materially from the results set forth in or implied in the forward-looking statements. Factors that might cause such a difference include:

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- General economic and business conditions,
  - Exposure to market risks in our financial instruments,
  - Fluctuations in worldwide prices and demand for oil and natural gas,
  - Fluctuations in the levels of our oil and natural gas exploration and development activities,
  - Risks associated with oil and natural gas exploration and development activities,

- Competition for raw materials and customers in the oil and natural gas industry,
- Technological changes and developments in the oil and natural gas industry,
- Regulatory uncertainties and potential environmental liabilities,