

21-Sep-2007

Annual Report

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

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. (the "Company" or "Daybreak") during the period covered by the financial statements. This MD&A should be read in conjunction with the audited financial statements and the related notes and other information included elsewhere in this 10-KSB report.

Additional information relating to Daybreak is available on EDGAR at www.edgar-online.com or our web site at www.daybreakoilandgas.com. Our stock is quoted on the NASDAQ over the counter (OTC.BB) market under the symbol DBRM.OB.

Safe Harbor Provision

Certain statements contained in our Management's Discussion and Analysis of Financial Condition or Plan of Operation are intended to be covered by the safe harbor provided for under Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. 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 at the beginning of this 10-KSB report.

Overview

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 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 Gilbertown project in Alabama. In the past we have relied on our working interest partners to negotiate all drilling, and sales contracts. Over the last fiscal year, 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 in eight (8) of these wellbores.

Long Term Success

Our success depends on 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.

Restated Financial Statements

In the process of responding to comments from the SEC (Securities and Exchange Commission) in regards to the SB-2 registration statement that we filed for the Spring 2006 private placement, we determined that it would be necessary to restate previously filed financial statements. The restated financial statements are included as a footnote to the financial statements that are included in this 10-KSB report. The four (4) quarters for the fiscal year ended February 28, 2006; the twelve months ended February 28, 2006; and the first three (3) quarters for the fiscal year ended February 28, 2007 (the "Restated Periods") are being restated. The determination to restate the financial statements for the Restated Periods is based on a reassessment of the following non-cash transactions:

- ° Pursuant to SFAS No. 123(R), an adjustment was recorded utilizing the market trading price on the date of grant as the more readily determinable fair value of stock issued for compensation to management and directors during the Restated Periods; and
- ° Pursuant to SFAS No. 123(R), an adjustment was recorded utilizing the market trading price on the date of grant as the more readily determinable fair value of stock issued for investor relations services during the Restated Periods; and
- ° Pursuant to SFAS No. 123(R), an adjustment was recorded utilizing the market trading price on the date of grant as the more readily determinable fair value of stock issued for oil and gas properties during the Restated Periods; and
- ° Pursuant to EITF 00-27 and 98-5, the recognition of a beneficial conversion feature (BCF) inherent in the convertible debentures issued during the Restated Periods. The recognition results in the recording of a discount to reflect the BCF and the recording of interest expense related to the discount.

Pursuant to SFAS No. 123R the guidelines for recording stock based compensation issued to officers and directors support that the more readily determinable fair value of

these shares should be based on the publicly traded share price of our shares at the grant date. The valuation of stock based compensation has been further addressed by the recent issuance of SFAS No. 157. This latest pronouncement also implies that shares issued to officers and directors for compensation should be valued at the publicly traded share price. Both of these pronouncements state that the valuation method can be applied even when, as in our case, compensation was issued to officers and directors in the form of unregistered shares which cannot be sold by the recipients until a full year has elapsed from their issuance. Accordingly, we have restated the impact of these share based payments to reflect the use of the publicly traded share price.

Again pursuant to SFAS No. 123(R), the guidelines for recording common stock issued for investor relations services and the acquisition of interests in oil and gas properties suggest that the more readily determinable fair value of these shares should be based on the publicly traded share price of our shares at the grant or acquisition date. SFAS No. 157 also suggests that when shares are issued for services or properties, they should be valued at the publicly traded share price. Accordingly, we have restated the impact of the share based payments for services and oil and gas properties to reflect the use of the publicly traded share price.

We also reviewed our prior determination of the fair value of shares resulting from the potential conversion of debt and concluded that we did not appropriately account for discounts in accordance with SFAS 123(R) and EITF 98-05. We have calculated the intrinsic value of the embedded beneficial conversion feature present in the convertible debt using quoted closing market prices on the date of each of the transactions.

This calculation has determined that \$1,138,701 in discounts should have been assigned to the convertible debt issuances at their respective inception. These discounts will be amortized over the period commencing on the issuance date to the earliest conversion date of the debt.

The accompanying financial statements for the twelve month period ended February 28, 2006, have been restated to effect the changes described above.

Selected Financial Information

Since our inception, we have incurred recurring losses from operations with negative cash flow and have depended on external financing to sustain our operations. During the fiscal year ended February 28, 2007, we reported losses of \$8,392,030. There is no assurance that we will be able to achieve profitability.

Our balance sheet on February 28, 2007, shows total assets of \$9,211,466 comprised primarily of oil and gas properties (net of Depreciation, Depletion, Amortization and Impairment) of \$4,552,850, cash and marketable securities for \$2,356,213, note receivable (including interest) for \$828,336 and accounts receivable (including trade, related parties and joint interest participants) of \$799,970. This compares with the

February 28, 2006 balances for oil and gas properties of \$1,132,400; cash and marketable securities for \$814,360 and deposits on equipment of \$250,000.

At February 28, 2007, we had total liabilities of \$2,544,884, comprised mainly of \$2,110,458 in accounts payable, \$134,999 in notes payable (net of discount), \$200,000 in pipeline financing obligation as compared with the February 28, 2006 balances for accounts payable of \$28,646 and notes payable (net of discount) of \$89,468.

Our common stock issued and outstanding has increased by 11,419,009 shares during the last fiscal year primarily as a result of the private placement from the spring of 2006. Preferred stock changed from zero at February 28, 2006, because of the July private placement of our Series A Convertible Preferred stock. The issued and outstanding shares increased to 1,399,765 at February 28, 2007, from the private placement.

Accumulated Deficit

The increase in the restated accumulated deficit during the exploration stage from \$4,472,041 to \$12,864,071 was due to the \$8,392,030 operating loss from the fiscal year ended February 28, 2007. This included \$1,196,640 of exploration and drilling expenses.

Cash Flows

1) Cash flow from operating activities for the fiscal year ended February 28, 2007, was (\$531,274) compared to (\$393,185) for the same period ending February 28, 2006. This was primarily caused by our operating loss of \$8,392,030 as compared to \$4,472,041 from the prior year. Principal operating activities in 2007 included a \$1.6 million impairment of oil and gas properties related to the Tensas Farms F-1 and F-3 wells in Louisiana and \$1.2 million of interest expense related primarily to accretion of debt discount.

2) Cash flow from investing activities for the fiscal year ended February 28, 2007, was (\$8,936,257) compared to (\$1,223,900) for the same period ending February 28, 2006. This difference was due to an increase in our investments in oil and gas properties of (\$5,904,956) compared with (\$973,900) from the prior fiscal year. Additional increases came from the deposits in money market funds (\$2,356,213) and additions to notes receivable (\$800,000).

3) Cash flow from financing activities for the fiscal year ended February 28, 2007, was \$9,039,461 compared to \$2,423,022 for the same period ending February 28, 2006. This difference was due to proceeds from the sale of our common stock of \$5,188,257 as compared to the sale of common stock from the prior year of 1,087,500. Another \$3,626,204 was received from proceeds of the convertible preferred stock in July 2006. Additionally, for the fiscal year ended February 28, 2007, the pipeline cost for the F-1 well in Louisiana was financed for \$200,000.

Liquidity and Capital Resources

Liquidity and Working Capital

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:

Current Ratio and Working Capital.

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

	February 28, 2007	February 28, 2006
Current Assets	\$ 4,537,634	\$ 1,074,610
Current Liabilities	\$ 2,445,457	\$ 118,114
Working Capital	\$ 2,092,177	\$ 956,496
Current Ratio	1.86	9.10

While these two ratios are important, numerous other factors may also affect the liquidity and capital resources of the Company. Working capital did increase from \$956,496 as of February 28, 2006, to \$2,292,177 as of February 28, 2007. This increase was principally due to the two private placements of our stock that were held during the fiscal year ended February 28, 2007.

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 necessary to fund our investment activities. As of February 28, 2007, 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. 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 with negative cash flow and have depended on external financing to sustain our operations. During the fiscal year ended February 28, 2007, we reported losses of \$8.1 million. 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. 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. Asset impairments of \$1,606,292 and \$-0- were recorded for the years ended February 28, 2007 and February 28, 2006, respectively. 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. As of February 28, 2007 \$70,266 had been advanced for services.

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 February 28, 2007 and February 28, 2006.

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.

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.

Restatements

We have restated our financial statements in accordance with SFAS No. 154, "Accounting Changes and Error Corrections". The financial statements were restated for the first three (3) quarters for the fiscal year ended February 28, 2006, for the twelve months ended February 28, 2006 and for the first three (3) quarters for the fiscal year ended February 28, 2007 (the "restated periods").

The financial statements were restated to reflect adjustments to non-cash transactions involving (1) the valuation of common stock issued for management and director compensation, (2) the valuation of common stock issued for investor relations services, (3) the valuation of common stock issued for the acquisition of oil and gas properties, and (4) the recognition of beneficial conversion features inherent in the convertible debentures issued during the restated periods.

In addition, the financial statements included herein 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.

Fiscal Year 2007 compared to Fiscal Year 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, fiscal year 2007 revenues of \$629,346 compares favorably to no revenues in the fiscal year 2006. During the fiscal year 2007, the Company recorded revenues from its interest in nineteen (19) producing wells. While these results are encouraging, the Company continues to experience mechanical and technical production problems with

certain major wells, particularly the F-1 well in the Tuscaloosa Prospect in Louisiana. This well contributed approximately 75% of total revenues in the fiscal year 2007.

The F-1 well was shut in pending the resolution of certain technical issues in November, 2006. Production on this property was re-established for a short period of time in February, 2007. The F-1 well was shut in again in late February 2007, 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 current year. However, there is no assurance that these efforts will be successful.

Cost and Expenses:

A table of our costs and expenses for the fiscal year 2007 compared to the fiscal year 2006 follows:

	Fiscal Year 2007	Fiscal Year 2006
-	\$ 373,766	\$ -
327,469	1,196,640	-
-	2,398,048	-
3,902,872	3,936,868	-
4,230,341	\$ 7,905,322	\$ -

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 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 from \$0 in the fiscal year 2006 to \$373,766 in the fiscal year 2007 relates entirely to the existence of revenues in fiscal year of 2007.

Exploration and drilling expenses increased substantially from \$327,469 in . . .