

PROBE RESOURCES LTD.
MANAGEMENT DISCUSSION AND ANALYSIS
As of November 30, 2008

This Management Discussion and Analysis was prepared on January 23, 2009.

Management's Discussion and Analysis should be read in conjunction with the audited consolidated financial statements for the year ended August 31, 2008 and the unaudited interim financial statements for the three months ended November 30, 2008. Barrel of oil equivalent ("boe") amounts have been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil ("6:1") unless otherwise stated. The audited consolidated financial statements and financial data contained in the MD&A have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") in Canadian currency.

Forward Looking Statements

Certain statements contained in this Management's Discussion and Analysis may constitute forward-looking statements. These statements relate to future events or the Company's future performance. All statements other than statements of historical fact may be forward-looking statements. Forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "continue", "estimate", "expect", "may", "will", "project", "predict", "potential", "targeting", "intend", "could", "might", "should", "believe" and similar expressions. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. The Company believes that the expectations reflected in those forward-looking statements are reasonable but no assurance can be given that these expectations will prove to be correct and such forward-looking statements included in this Management's Discussion and Analysis should not be unduly relied upon by investors. These statements speak only as of the date of this Management's Discussion and Analysis and are expressly qualified, in their entirety, by this cautionary statement.

In particular, this Management's Discussion and Analysis contains forward-looking statements, pertaining to the following:

capital expenditure programs;

- i. treatment under governmental regulatory and taxation regimes; and
- ii. expectations regarding the Company's ability to raise capital and to continually add to reserves through acquisitions and development.

With respect to forward-looking statements contained in this Management's Discussion and Analysis, the Company has made assumptions regarding, among other things:

- iii. the Company's ability to obtain additional financing on satisfactory terms.

The Company's actual results could differ materially from those anticipated in these forward-looking statements as a result of the risk factors set forth below and elsewhere in this management discussion and analysis:

- iv. geological, technical, drilling and processing problems;
- v. liabilities and risks, including environmental liabilities and risks, inherent in oil and natural gas operations;

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- vi. incorrect assessments of the value of acquisitions;
- vii. competition for, among other things, capital, acquisitions of reserves, undeveloped lands and skilled personnel; and
- viii. the other factors referred to under “Risk Factors”.

The forward-looking statements or information contained in this Management’s Discussion and Analysis are made as of January 23, 2009, and the Company undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless required by applicable securities laws.

Success in the junior oil and gas sector is measured by a Company’s ability to raise funds and the ability to secure properties of merit. Not all of these factors are within management’s control. The ability to raise funds is in part dependent on the state of the junior resource stock market, which in turn is dependent on the economic climate, oil and gas prices and perceptions as to which way the market is headed. The ability to secure properties of merit is in large part dependent on management’s contacts and the vitality of the sector.

The financial statements have been prepared on a going concern basis which contemplates the realization of assets and the payment of liabilities in the ordinary course of business. Should the Company be unable to continue as a going concern it may be unable to realize the carrying value of its assets and to meet its liabilities as they become due.

The Company's ability to continue as a going concern is dependent upon its ability to discover economically recoverable reserves, to bring such reserves into production and attain profitable operations, and to obtain financing from third parties sufficient to meet current and future obligations. These financial statements do not reflect the adjustments or reclassification of assets and liabilities which would be necessary if the Company were unable to continue its operations.

The Company is still in the development stage and will require additional capital in the form of debt or equity to compete its business plans.

Description of Business

Probe Resources Ltd. (the “Company”) is a public company listed and publicly traded on the TSX Venture Exchange, incorporated under the British Columbia Business Corporations Act on November 15, 1988. At November 30, 2008, the Company was in the development stage as an oil and natural gas company, owning an interest in an oil and natural gas producing property and interest in six federal oil and natural gas blocks located in the United States Gulf of Mexico.

The management of the Company will prudently seek investment and/or joint venture opportunities that are attractive to the current shareholders and that will create long term value for its shareholders.

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Discussion of Gulf of Mexico Operations

- A. High Island 115 - During the year ended August 31, 2007, the Company acquired a 33.574% working interest (25.1875% net revenue interest) in an oil and natural gas lease and well located in the High Island area of the Gulf of Mexico by way of a Farmout Agreement dated June 1, 2007 and amended July 16, 2007. Consideration for the acquisition was \$583,495 (US\$550,000) which was paid subsequent to the period and 33.574% of all costs except for certain well costs of which the Company's share to be paid is 46.30896%. The Company has also agreed to a 72.5% share of the flowline costs. In December 2007, the Company purchased an additional 13.4291% working interest (10.075% net revenue interest) in the lease and a 7.97087% working interest (5.73113% net revenue interest) in the well. Consideration for the additional interest is the issue of 3,000,000 common shares at a deemed price of \$0.445 per share. As at August 31, 2008, the well had been completed with production having commenced in late November of 2007. Accordingly, depreciation, depletion and amortization have been recorded since December 1, 2007. Management has evaluated the carrying value and has determined that no impairment provision is required at November 30, 2008.

On September 13, 2008, the well's platform, departing export line, host platform at High Island 71 and the onshore facilities were all damaged in varying degrees by Hurricane Ike. As a result, the well has not produced since that date. Repairs to the facilities have been substantially completed as January 23, 2009, and the return to production is imminent.

- B. East Cameron 36 – On August 25, 2008 the Company announced discovery of commercial reserves in multiple horizons in its East Cameron 36 No. 1 well. The well was spud on August 5, 2008 and was drilled under budget to a total depth of 10,450 feet. Production casing has been installed in the well, a caisson has been over-driven, and a caisson deck installed. The Company is evaluating the development plan on the East Cameron 36 No. 1 well. The Company expects to conduct additional drilling in the East Cameron 36 and East Cameron 37 blocks in 2009 depending upon the availability of funds. Probe holds a 100% WI and a 69.5% NRI in the well.
- C. East Cameron 246 - On October 30, 2008 the Company announced discovery of commercial reserves in its East Cameron 246 No. 2 well. The Company encountered its primary objective in the Lentic formation logging approximately 45 feet of net pay. The expected gross production rate from this formation is 10 to 15 MMcf of gas per day. Upon completion of the drilling activities, production casing has been run, and the well has been suspended awaiting production facilities. Further drilling in the field is planned during 2009 depending upon the availability of funds. The Company holds a 100% working interest (“WI”) and a 70% net revenue interest (“NRI”) in the well.
- D. South Timbalier 214 – On January 5, 2009 the Company announced the discovery of commercial reserves in the South Timbalier A-6 Sidetrack # 1 well. The well was drilled to 15,825' measured depth and 14,751' true vertical depth (“TVD”). The Company encountered its primary objective in the Buliminella 1 formation, logging

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approximately 88' of TVD net pay. The anticipated gross production rate from this formation is 25 – 30 MMcfd based on similar well performance in the area. Probe holds a 100% WI and a 70% NRI in the well.

The well has been completed and production is anticipated to commence by the end of January 2009. The well was drilled from a Probe-owned production platform in the adjacent block which is connected to the NYMEX premium market via a ready-for-service export pipeline.

Agreements to Purchase Oil and Gas Rights

On May 22, 2008, the Company's wholly-owned subsidiary Probe Resources US Ltd. ("Probe US") entered into an agreement (the "Agreement") with certain arm's length parties (the "Vendors") to purchase 75% working interest rights associated with approximately 26,500 acres on six (6) Federal oil and natural gas lease blocks located in the United States Gulf of Mexico (collectively, the "Concessions"). After completion of the Cutter transaction, as described below, the Company became the Operator of the Concessions on a 100% working interest basis.

Pursuant to the terms of the Agreement, the Vendors along with Cutter have delivered to Probe US not less than a 69.5% net revenue interest in each of the Concessions. Probe US paid an aggregate amount of US\$4,250,000 as consideration to the Vendors. The Agreement provides Probe US the opportunity to conduct a drilling program on the Concessions.

On June 6, 2008, the Company agreed to acquire 25% working interest rights from Cutter Energy on 26,500 acres in six (6) Federal oil and gas lease blocks located in the United States Gulf of Mexico (collectively, the "Concessions"). It is in respect to these same Concessions that Probe completed the acquisition of 75% working interest rights dated May 22, 2008, as described above. Probe is the Operator of the Concessions on a 100% working interest rights basis. Cutter Energy is owned by Scott Broussard (President, CEO, and Chairman of Probe) and the acquisition is, therefore, considered to be a non arms-length transaction. Total consideration for the working interest rights includes a payment to Cutter of USD\$829,594 cash, and up to 4,000,000 Common Shares at a deemed price of \$.50 per Common Share. The Company issued 2,000,000 of the 4,000,000 Common Shares upon TSC Venture Exchange approval of this transaction. In addition, the Company will grant Cutter 666,666 Common Shares for each occurrence of up to three successful wells at distinct leases within 24 months from the date of the agreement.

Other Interests - Seismic Data

During the year ended August 31, 2007, the Company obtained access to seismic data related to certain properties located in onshore South Texas, South Louisiana and South Mississippi, U.S.A. for consideration of \$233,644 (US\$200,000). The Company also engaged another company to review and evaluate the data for a fee of US\$40,000 per month. Subsequent to the consulting arrangement, a director of the other company became a director of the Company. Total capitalized seismic data costs incurred to August 31, 2008 are \$773,951 (US\$730,000).

During September, 2008, the Company entered into agreements to obtain seismic data covering the Company's South Timbalier 214, East Cameron 36 and East Cameron 246 project areas for a total of US \$566,000.

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Selected Annual Information

The following financial data are selected information for the Company for the three most recently completed financial years:

| | Year ended August 31, | | |
|--|-----------------------|---------------|--------------|
| | 2008 | 2007 | 2006 |
| Total revenues | \$ 5,110,861 | \$ - | \$ - |
| Loss before other items | \$(4,463,157) | \$(1,154,252) | \$(152,859) |
| Basic and diluted loss per share before other item | \$(0.10) | \$(0.09) | \$(0.01) |
| Net loss | \$(4,076,271) | \$(1,084,602) | \$(306,566) |
| Basic and diluted loss per share | \$(0.09) | \$(0.08) | \$(0.02) |
| Total assets | \$46,562,135 | \$ 8,195,337 | \$ 280,973 |
| Total long-term liabilities | \$ 861,510 | \$ 531,632 | \$ - |
| Cash dividends per share | \$ - | \$ - | \$ - |

Summary of Quarterly Results

The following is a summary of the Company's financial results for the eight most recently completed quarters:

| | Q1 Nov 30 <u>2008</u> | Q4 Aug 31 <u>2008</u> | Q3 May 31, <u>2008</u> | Q2 Feb 29, <u>2008</u> | Q1 Nov 30, <u>2007</u> | Q4 Aug 31, <u>2007</u> | Q3 May 31, <u>2007</u> | Q2 Feb 28, <u>2007</u> |
|--------------------------|-----------------------------|-----------------------------|------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|
| Total revenues | \$72,279 | \$1,859,556 | \$2,007,280 | \$1,244,025 | \$- | \$- | \$- | \$- |
| Loss before other items: | | | | | | | | |
| Total | \$(1,645,389) | \$(2,552,427) | \$(354,535) | \$(336,704) | \$(1,219,491) | \$(975,509) | \$(84,234) | \$(49,938) |
| Per share | \$(0.02) | \$(0.03) | \$(0.01) | \$(0.02) | \$(0.04) | \$(0.04) | \$(0.00) | \$(0.00) |
| Net loss: | | | | | | | | |
| Total | \$(990,335) | \$(2,090,181) | \$(430,816) | \$(335,930) | \$(1,219,344) | \$(977,420) | \$ 1,260 | \$(65,083) |
| Per share | \$(0.01) | \$(0.02) | \$(0.01) | \$(0.02) | \$(0.04) | \$(0.04) | \$(0.00) | \$(0.00) |

Results of Operations

The following table summarizes production volumes, average sales prices and operating revenues for the three months ended November 30, 2008 and 2007:

| | <u>2008</u> | <u>2007</u> |
|---------------------|------------------|-------------|
| Production Volumes | | |
| Oil (Bbl) | 41 | - |
| Natural gas (Mcf) | 8,263 | - |
| Average Sales Price | | |
| Oil | \$ 112.37 | \$ - |
| Natural Gas | \$ 8.19 | |
| Operating Revenue | | |
| Oil | \$ 4,607 | \$ - |
| Natural Gas | <u>67,672</u> | <u>-</u> |
| Total | <u>\$ 72,279</u> | <u>\$ -</u> |

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The Company reported a net loss of \$990,335 for the three months ended November 30, 2008, compared to a net loss of \$ 1,219,344 for the three months ended November 30, 2007. The net production revenue was a loss of \$361,157 for the three months ended November 30, 2008 compared to \$ nil for the three months ended November 30, 2007. The loss for the first quarter of the current fiscal year was the result of the High Island 115 well being shut in during most of quarter and the lease operating expenses were primarily repairs, both as a result of Hurricane Ike. The general and administrative expenses for the three months ended November 30, 2008 were relatively unchanged at \$1,284,233 compared to \$1,231,652 for the three months ended November 30, 2007.

Financings, Principal Purposes and Milestones

On November 16, 2007, the Company issued 4,200,000 units at \$0.50 per unit pursuant to a private placement for gross proceeds of \$2,100,000. Each unit consisted of one common share and one share purchase warrant entitling the holder thereof the right to purchase an additional common share for each warrant held at \$0.60 per share for one year. In addition, the Company paid finders' fees of \$52,500 and issued 168,350 units as finders' fees with the same terms as the private placement units.

On December 19, 2007, the Company issued 275,000 units at \$0.60 per unit pursuant to a private placement for gross proceeds of \$165,000. Each unit consists of one common share and one share purchase warrant entitling the holder thereof the right to purchase an additional common share for each warrant held at \$0.70 per share for one year.

During the quarter ended November 30, 2007, the Company granted share purchase options entitling the holders thereof the right to purchase 200,000 common shares of the Company at \$0.47 per share until September 20, 2009, 100,000 common shares at \$0.49 per share until October 26, 2012, and 1,250,000 common shares at \$0.60 per share until November 22, 2012.

On December 19, 2007, the Company issued 3,000,000 common shares pursuant to an assignment agreement in which the Company acquired an additional 13.4291% working interest (10.0751% net revenue interest) in the High Island oil and natural gas lease and a 7.97087% working interest (5.73113% net revenue interest) in the well. The Company also issued 275,000 units at \$0.60 per unit pursuant to a private placement for gross proceeds of \$165,000. Each unit consisted of one common share and one non-transferable share purchase warrant entitling the holder thereof the right to purchase an additional common share for each warrant held at \$0.70 per share for one year.

On March 5, 2008, the Company announced a best efforts private placement of up to 40,000,000 units (each, a "Unit") of the Company at a price of \$0.50 per Unit for gross proceeds of up to \$20,000,000 (the "Offering"), which did not proceed.

On June 6, 2008, the Company closed a non-brokered private placement consisting of 16,000,000 Units (each, a "Unit") at a price of \$0.40 per Unit, for gross proceeds of \$6,400,000. Each Unit consisted of one common share of the Company (each a "Share") and one transferable share purchase warrant (the "Warrants"). Each Warrant entitled the holder thereof to purchase one

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additional Share for a two-year period expiring on June 3, 2010 at an exercise price of \$0.40 per Share. The Company incurred legal and filing fees of \$53,052 and finders' fees of \$77,000. In addition, the Company issued 511,875 units as finders' fees with the same terms as the private placement units. All proceeds on the issue of units have been allocated to share capital and none to warrants. The net proceeds from the Offering were used by the Company to complete the acquisition of licenses in certain oil and natural gas leases in the U.S. Gulf of Mexico, the settlement of debt obligations and for general working capital.

On July 2, 2008, the Company closed a best efforts brokered private placement consisting of 54,720,000 Units (each, a "Unit") at a price of \$0.50 per Unit, for gross proceeds of \$27,360,000. Each Unit consisted of one common share of the Company (each a "Share") and one transferable share purchase warrant (the "Warrants"). Each Warrant entitled the holder thereof to purchase one additional Share for a one-year period expiring on June 30, 2009 at an exercise price of \$0.75 per Share. The brokers received a cash commission of \$1,726,400 representing 6.5% of the gross proceeds raised in the Offering (excluding proceeds raised from the sale of Units in the United States) and a total of 2,656,000 non-transferable compensation options (each an "Broker Option") representing 5% of the Units sold in the Offering. Each Broker Option entitles the holder thereof to purchase one Share for a one-year period expiring on June 30, 2009 at an exercise price of \$0.50 per Share. The brokers also received a corporate finance fee of \$52,000.

During the year ended August 31, 2008, a claim was made against the Company and another party for amounts allegedly advanced by third parties in the amount of \$399,736. This claim was settled on February 18, 2008 and the Company was released from the claim.

Capital Resources

The Company's first three wells from the May 22, 2008 purchase agreements described above will be funded by a combination of the proceeds of the brokered private placement closed in July 2008, debt and operating cash flow. With success, the Company anticipates the development of those fields and the drilling and completion of an additional six wells from that transaction that are expected to be funded by a combination of debt, proceeds of the exercise of outstanding share warrants, an additional equity offering and operating cash flow. The actual number of wells drilled may vary depending upon various factors, including the availability and cost of drilling rigs, success of the initial three wells, weather delays, regulatory issues and other factors. We may not be able to obtain the funding described above on terms that would be acceptable to us. If we cannot obtain adequate funding, we may be required to limit or defer our planned drilling program.

Off Balance Sheet Arrangements

There are no off-balance sheet arrangements to which the Company is committed.

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Commitments

Contractual Obligations:

Operating Leases

The Company has a non-cancelable operating lease for its office facility. The lease has schedule increases, requires the Company to pay its share of operating costs, and expires in 2013.

Future minimum payments under operating lease for the next five years are as follows:

| | |
|-------------------|-----------|
| November 30, 2009 | \$317,480 |
| November 30, 2010 | \$329,721 |
| November 30, 2011 | \$329,721 |
| November 30, 2012 | \$341,964 |
| November 30, 2013 | \$343,077 |

Drilling Commitments

At November 30, 2008, the Company had entered into two drilling contracts. The Company had entered into a contract to drill the East Cameron 246 #2 well at a rate of \$59,700 per day plus ancillary costs. The Company had also entered into a contract to drill the South Timbalier 214 #A-6 Sidetrack #1 well at a rate of \$78,500 per day plus ancillary costs.

Contingency

The Company's 100% owned U.S. subsidiary, Probe Resources US Ltd. ("Probe US"), along with an officer of the Company, have been named as defendants in a petition filed in the State Court of Texas, USA during September 2008 and amended in November 2008 to add Probe US and the officer as defendants. The lawsuit alleges that Probe US and the officer used information in violation of a confidentiality agreement to acquire certain properties. The petition has, among other things, petitioned for the establishment of a constructive trust for the revenue from the plaintiff's alleged interest in the properties and has requested unspecified damages as a result of the utilization of the confidential information. Neither Probe US nor its officers have ever had any contractual relationships with the plaintiff. The Company believes that the plaintiff's claims are without merit and accordingly no provision has been provided in the financial statements. The company has filed its Original Answer with the State Court of Texas and denied all allegations. The Company intends to vigorously defend the claims made in the lawsuit.

Related Party Transactions

In the course of regular business activities, the Company enters into transactions with related parties from time to time. During the three months ended November 30, 2008 and 2007, the Company incurred the following fees charged by directors of the Company or by entities of which a director is a partner or entities with directors in common with the Company:

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| | <u>2008</u> | <u>2007</u> |
|--------------------------------------|-----------------------------|-------------------|
| Consulting fees | \$ - | \$ 20,000 |
| Corporate development | - | 12,000 |
| Directors' fees | 13,000 | 8,000 |
| Drilling, completion and other costs | - | 120,000 |
| Legal fees | 57,369 | 114,357 |
| Wages and Salaries | <u> </u> | <u>17,000</u> |
| | <u>\$ 70,369</u> | <u>\$ 291,357</u> |

These charges were measured by the exchange amount which is the amount agreed upon by the transacting parties.

At November 30, 2008, accounts payable and accrued liabilities include \$114,496 (2007: \$52,436) due to directors of the Company or to private companies with directors in common with the Company.

At November 30, 2008, an officer of the Company was indebted to the Company for \$9,428 (2007: \$Nil) from payroll advances.

On June 6, 2008, the Company agreed to acquire 25% working interest rights from Cutter Energy on 26,500 acres in six (6) Federal oil and gas lease blocks located in the United States Gulf of Mexico (collectively, the "Concessions"). It is in respect to these same Concessions that Probe completed the acquisition of 75% working interest rights dated May 22, 2008, as described in Note 5. Probe is the Operator of the Concessions on a 100% working interest rights basis. Cutter Energy is owned by Scott Broussard (President, CEO, and Chairman of Probe) and the acquisition is, therefore, considered to be a non arms-length transaction. Total consideration for the working interest rights includes a payment to Cutter of USD\$829,594 cash, and up to 4,000,000 Common Shares at a deemed price of \$.50 per Common Share. The Company issued 2,000,000 of the 4,000,000 Common Shares upon TSC Venture Exchange approval of this transaction. In addition, the Company will grant Cutter 666,666 Common Shares for each occurrence of up to three successful wells at distinct leases within 24 months from the date of the agreement.

On September 2, 2008, the Company advanced \$750,000 to an officer of the Company as a relocation/home ownership loan. The advance bears interest at 5% and is repayable on the earlier of January 1, 2010, or immediately in the case of the borrower's termination of the employment agreement dated February 12, 2008. The loan will be forgiven as to 50% after one year and the remaining 50% after the second year unless the employment is terminated. The first 50% of the loan was forgiven on January 1, 2009.

Liquidity and Solvency

At November 30, 2008, the Company had a working capital deficiency of \$7,820,985, it had not yet achieved profitable operations and expects to incur further losses in the development of its business, which cast substantial doubt about the Company's ability to continue as a going concern. The Company's ability to continue as a going concern is dependent upon its ability to generate future profitable operations and/or to obtain the necessary financing to meet its obligations and repay its liabilities arising from normal business operations when they come due. The Company

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has entered into two financing transactions totaling in excess of USD\$14.0 million (as more fully described below) to assist in its ability to meet its obligations.

Accounting Changes

The Company adopted the new financial instruments accounting policy during the year end August 31, 2008.

International Financial Reporting Standards

In February 2008, the CICA Accounting Standards Board (“AcSB”) confirmed a strategic plan for the direction of accounting standards in Canada. As part of that plan, accounting standards in Canada for public companies will converge with International Financial Reporting Standards (“IFRS”), effective January 1, 2011. The Company continues to monitor and assess the impact of the convergence of Canadian GAAP and IFRS.

Risks

A number of factors could cause the Corporation’s results to differ materially from its expectations. Readers should carefully review the following factors, and all information contained elsewhere on SEDAR. Exploration for oil and natural gas and foreign offshore operations involve many risks, which even a combination of experience, knowledge and careful evaluation may not be able to overcome. There is no assurance that commercial quantities of oil and natural gas will be discovered by the Corporation. Risk factors include: risks associated with the exploration for and development of oil and natural gas reserves; operational risks and liabilities that are not covered by insurance; volatility in market prices for oil, NGLs and natural gas; the ability of the Corporation to fund its substantial capital requirements and operations; risks associated with ensuring title to the Corporation’s properties; changes in environmental or other legislation applicable to the Corporation’s operations, and the Corporation’s ability to comply with current and future environmental and other laws; the accuracy of oil and gas reserve and resource estimates and estimated production levels as they are affected by the Corporation’s exploration and development drilling and estimated decline rates; the Corporation’s success at acquisition, exploration, exploitation and development of reserves and resources; the Corporation’s reliance on key operational and management personnel; the ability of the corporation to obtain and maintain all of its required permits and licenses; competition for, among other things, capital, drilling equipment, acquisitions of reserves, undeveloped lands and skilled personnel; changes in general economic, market and business conditions in Canada, and worldwide; actions by governmental or regulatory authorities including changes in income tax laws or changes in tax laws, royalty rates and incentive programs relating to the oil and gas industry; adverse regulatory rulings, orders and decisions.

Current volatility in the economies of the United States and worldwide may impact the Company’s future performance. Declines in the prices of natural gas and oil in the United States may lessen cash flows. Falling demand for rigs and other services and equipment may have a positive impact on future drilling costs. Less equity capital and debt availability may slow development projects and may require more reliance on internally generated cash flow. Industry

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practices of sharing risk with the formation of joint ventures may require a tightening and more restricted selection of joint venture partners.

Critical Accounting Estimates

Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of financial statements for a period necessarily involves the use of estimates, which have been made using careful judgment. Actual results may differ from these estimates.

Management's opinion is that the financial statements have been properly prepared within the framework of the significant accounting policies, certain of which are summarized as follows:

a) Oil and Natural Gas Properties

The Company follows the full cost method of accounting for oil and natural gas operations whereby all costs of exploring for and developing oil and natural gas reserves are initially capitalized on a country-by-country basis. Such costs include land acquisition costs, lease rentals, geological and geophysical expenses, carrying charges on non-producing properties, costs of drilling and overhead charges directly related to acquisition and exploration activities.

Costs capitalized, together with the costs of production equipment and pipeline, are depleted and amortized on the unit-of-production method based on the estimated gross proved reserves as determined by independent petroleum engineers. Petroleum products and reserves are converted to a common unit of measure, using 6 MCF of natural gas to one barrel of oil.

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These unevaluated 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 the impairment is added to costs subject to depletion calculations.

Proceeds from a sale of oil and natural gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would significantly alter the rate of depletion and amortization.

In applying the full cost method, the Company calculates a ceiling test whereby the carrying value of oil and natural gas properties is compared to the sum of the undiscounted cash flows expected to result from the proved reserves and the lower of cost or market of unproved properties.

The recoverability of amounts shown for unproven properties is dependent upon the discovery of economically recoverable reserves, the ability of the Company to obtain necessary financing to complete the development of the properties and upon future profitable production or proceeds from the disposition thereof.

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b) Asset Retirement Obligations

The fair value of obligations associated with the retirement of tangible long-lived assets are recorded in the period in which it is incurred and a reasonable estimate of the fair value can be made, with a corresponding increase to the carrying amount of the related asset. The obligations recognized are statutory, contractual or legal obligations. The liability is accreted over time for changes in the fair value of the liability through charges to accretion. The costs capitalized to the related assets are amortized in a manner consistent with the depreciation, depletion and amortization of the related asset.

c) Stock-based Compensation

The fair value of all share purchase options granted is expensed over their vesting period with a corresponding increase to contributed surplus. Upon exercise of share purchase options, the consideration paid by the option holder, together with the amount previously recognized in contributed surplus, is recorded as an increase to share capital.

The Company uses the Black-Scholes option valuation model to calculate the fair value of share purchase options at the date of grant. Option pricing models require the input of highly subjective assumptions, including the expected price volatility. Changes in these assumptions can materially affect the fair value estimate.

Disclosure of Outstanding Share Data

As at January 23, 2009, authorized share capital for the Company was unlimited common shares without par value. A total of 104,383,200 common shares have been issued as follows:

| | <u>Share Capital</u> | | <u>Contributed Surplus</u> |
|--|-----------------------------|---------------|--------------------------------|
| | <u>Number of Shares</u> | <u>Amount</u> | |
| Balance, September 1, 2007 | 24,109,101 | \$ 7,691,846 | \$ 1,090,364 |
| Issued for acquisition of | | | |
| -oil and natural gas properties – at \$0.445 | 3,000,000 | 1,335,000 | - |
| -oil and natural gas properties – at \$0.50 | 2,000,000 | 1,000,000 | - |
| Issued for cash pursuant to | | | |
| -private placement agreements - at \$0.50 | 4,200,000 | 2,100,000 | - |
| -private placement agreements - at \$0.60 | 275,000 | 165,000 | - |
| -private placement agreements - at \$0.40 | 15,999,999 | 6,400,000 | - |
| -private placement agreements - at \$0.50 | 54,720,000 | 27,360,000 | - |
| Issued for | | | |
| -finder's fees - at \$0.40 | 168,350 | 84,175 | - |
| -finder's fees - at \$0.50 | 511,875 | 204,750 | - |
| Less: share issue costs | - | (3,717,469) | 1,150,707 |

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| | | | |
|--|--------------------|---------------------|--------------------|
| Share purchase options | | | 1,548,822 |
| Cancelled escrow shares | <u>(601,125)</u> | - | <u>-</u> |
| Balance, August 31, 2008 | 104,383,200 | \$42,623,302 | \$3,789,892 |
| Share purchase options | <u>-</u> | <u>-</u> | <u>141,486</u> |
| Balance, Nov 30, 2008 and Jan 23, 2009 | <u>104,383,200</u> | <u>\$42,623,302</u> | <u>\$3,931,179</u> |

Share purchase warrants outstanding at January 23, 2009 are as follows:

| <u>Number of Warrants</u> | <u>Exercise Price</u> | <u>Expiry Date</u> |
|-------------------------------|---------------------------|---------------------------------|
| 10,000,000 | \$0.75 | February 9, 2009 ⁽¹⁾ |
| 275,000 | \$0.70 | February 14, 2009 |
| 16,511,874 | \$0.50 | June 6, 2010 |
| 2,656,000 | \$0.50 | June 30, 2009 |
| 54,720,000 | \$0.75 | June 30, 2009 |
| 2,800,000 | \$0.20 | January 20, 2014 |
| <u>112,000</u> | <u>\$0.25</u> | <u>January 20, 2014</u> |
| <u>87,074,874</u> | | |

- (1) Subject to an acceleration provision whereby, if the Company's shares trade above \$0.75 for 20 consecutive trading days after the expiration of their hold period, the Company may give notice that the warrants will expire in 30 days if unexercised.

The Company agreed to extend the term of warrants (the "Warrants") to purchase a total of 10,000,000 common shares of the Company from 12 months from the date of issuance to 18 months from the date of issuance. The new expiry date for the Warrants to purchase a total of 10,000,000 will be February 9, 2009, provided that, the Company is entitled to accelerate the expiry date of the Warrants to the date that is 30 days following the date a notice to holders of Warrants advising that the published closing price of the common shares of the Company on the TSX Venture Exchange has been greater than \$0.75 for 20 consecutive trading days.

During the year ended August 31, 2008, 363,500 unvested share purchase options exercisable at \$0.67 until July 26, 2012 and 650,000 unvested share purchase options exercisable at \$0.60 until November 22, 2012 were cancelled due to directors' resignations. In connection with the resignations, 413,500 vested share purchase options exercisable at \$0.67 until July 26, 2012 expired unexercised, and 350,000 vested share purchase options exercisable at \$0.60 until November 22, 2012 expired unexercised subsequent to August 31, 2008.

On February 29, 2008, the Company exercised its right to terminate the service agreement (the "Agreement") with its investor relation consultant. In connection with the termination, 100,000 share purchase options unvested were cancelled and the vested 100,000 share purchase options

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exercisable at \$0.47 until September 20, 2009 expired on April 30, 2008 (30 days after the termination of the Agreement).

During March, 2008, the Company granted incentive stock options to certain directors, officers and employees of the Company to purchase up to 3,799,000 (March 5, 2008 – 3,243,000 and March 26, 2008 – 556,000) common shares in the capital stock of the Company. The options have a term of five years and are exercisable at an exercise price of \$0.40 per share.

On June 1, 2008, the Company has granted incentive stock options to certain employees of the Company to purchase up to 300,000 common shares in the capital stock of the Company. The options have a term of five years and are exercisable at an exercise price of \$0.50 per share.

On October 2, 2008, the Company granted incentive stock options to certain employees of the Company to purchase up to 370,000 common shares in the capital stock of the Company. The options have a term of five years and are exercisable at an exercise price of \$0.40 per share.

Share purchase options outstanding at December 17, 2008 are as follows:

| <u>Number of Options</u> | <u>Exercise Price</u> | <u>Expiry Date</u> |
|------------------------------|---------------------------|--------------------|
| 563,910 | \$0.67 | July 26, 2012 |
| 100,000 | \$0.49 | October 26, 2012 |
| 250,000 | \$0.60 | November 22, 2012 |
| 3,243,000 | \$0.40 | March 5, 2013 |
| 556,000 | \$0.40 | March 5, 2013 |
| 300,000 | \$0.50 | June 1, 2013 |
| <u>370,000</u> | \$0.40 | October 2013 |
| <u>5,382,910</u> | | |

Financial Instruments

The carrying value of cash and cash equivalents and accounts payable and accrued liabilities approximate their fair value because of the short-term maturity of those instruments.

Subsequent Events

Note Issue

The Company has entered into a Note Purchase Agreement whereby the Company has agreed to issue and sell senior secured notes in the aggregate principal amount of USD\$10,000,000 (the “Notes”) to a Single Holder (the “Holder”). The approximate net proceeds to the Company, as a result of the negotiated discount to face value of the Notes, is CDN\$7,000,000. In addition, the Notes bear interest at a rate of 15% per annum, fixed and payable monthly in arrears on principal outstanding. The principal will be re-paid by monthly payments of USD\$200,000. The initial term of the Notes is two years with an extension option at the election of the Company for an additional two years upon payment of an extension fee of \$300,000 in each of the second and third years of the total term. As additional compensation the Holder will receive

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7,000,000 share purchase warrants exercisable into 7,000,000 common shares of the Company at a price of \$0.20 per share for a period of five years from the closing date.

The Company has closed a US\$4,000,000 tranche of the issue of Notes for CDN\$2,800,000 (USD\$2,200,047 net proceeds to the Company) in connection therewith. The Company has issued 2,800,000 of the 7,000,000 warrants to the Holder where each Warrant entitles the Holder thereof to purchase one common share of the Company on or before January 20, 2014 at an exercise price of \$0.20 per share. Shares issuable on the exercise of the warrants have a hold period expiring May 21, 2009. Closing of the balance of the First Note issue is expected in the very near term. The Company intends to use the proceeds of the issuance of the Notes to fund drilling of ST 214.

Fees in connection with the issue of the Notes will be paid equal to 4% of the funds raised and 4% in warrants of the Company exercisable into common shares at a price of \$0.25 per warrant for a period of five years from the date of closing.

Credit Facility

The Company has also entered into a conditional agreement in principal pursuant to which an institutional lender (“the Lender”) will provide to the Company a USD\$8,500,000 loan (the “Loan”). The Loan will be for a term of six months from the date of advance, or such other date as mutually agreed (the “Maturity Date”). Interest will be at an annual rate of 18% payable and compounded monthly on amounts outstanding at month end. Regular principal payments will be made over a six-month period which will, upon completion, retire the Loan. In consideration of the Loan the Lender will receive a \$480,000 commitment fee and 7,000,000 share purchase warrants to purchase 7,000,000 common shares of the Company at a price of \$0.25 per share for a period of four years from the closing date.

The proceeds of the Loan will be used for the well completion and tie-in of the ST214 well, exclusive of drilling costs, which are being funded by the above referenced Note facility with the Holder.

Fees will be paid in connection with the Loan equal to 4% of the funds raised by the Company and 4% in warrants of the Company exercisable into a common share at a price of \$0.25 per warrant for a period of four years from the date of closing.

For further information, please contact the Company.

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PROBE RESOURCES LTD.