

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

**For the quarterly period ended August 31, 2020**

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-50107

**DAYBREAK OIL AND GAS, INC.**

(Exact name of registrant as specified in its charter)

**Washington**

**91-0626366**

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

**1101 N. Argonne Road, Suite A 211, Spokane Valley, WA**

**99212**

(Address of principal executive offices)

(Zip code)

(509) 232-7674

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
n/a	n/a	n/a

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

At October 14, 2020 the registrant had 60,491,122 outstanding shares of \$0.001 par value common stock.

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**PART I  
FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**DAYBREAK OIL AND GAS, INC.**

**Balance Sheets – Unaudited**

	As of August 31, 2020	As of February 29, 2020
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 19,101	\$ 94,043
Accounts receivable:		
Crude oil sales	62,418	56,910
Joint interest participants	40,661	38,366
Prepaid expenses and other current assets	16,289	51,115
Total current assets	<u>138,469</u>	<u>240,434</u>
<b>LONG-TERM ASSETS:</b>		
Crude oil properties, successful efforts method, net		
Proved properties	572,916	598,735
Unproved properties	55,978	55,978
Prepaid drilling costs	16,452	16,452
Operating lease, right-of-use asset	1,464	5,857
Total long-term assets	<u>646,810</u>	<u>677,022</u>
Total assets	<u>\$ 785,279</u>	<u>\$ 917,456</u>
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable and other accrued liabilities	\$ 1,619,475	\$ 1,555,700
Accounts payable – related parties	934,960	919,888
Accrued interest	98,914	73,962
Convertible note payable – related party	—	27,835
12% Notes payable	315,000	315,000
12% Notes payable – related party	250,000	250,000
Production revenue payable – current, net of unamortized discount	64,798	43,069
Paycheck protection program (PPP) loan	74,355	—
Operating lease liability – current	1,464	5,857
Line of credit	857,107	872,401
Total current liabilities	<u>4,216,073</u>	<u>4,063,712</u>
<b>LONG TERM LIABILITIES:</b>		
Note payable	120,000	120,000
Production revenue payable, net of unamortized discount and current portion	1,390,125	1,345,202
Asset retirement obligation	29,103	27,149
Total long-term liabilities	<u>1,539,228</u>	<u>1,492,351</u>
Total liabilities	<u>5,755,301</u>	<u>5,556,063</u>
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' DEFICIT:</b>		
Preferred stock – 10,000,000 shares authorized, \$0.001 par value;	—	—
Series A Convertible Preferred stock – 2,400,000 shares authorized, \$0.001 par value, 6% cumulative dividends; 709,568 shares issued and outstanding	710	710
Common stock – 200,000,000 shares authorized; \$0.001 par value, 60,491,122 and 53,532,364 shares issued and outstanding, respectively	60,491	53,532
Additional paid-in capital	24,247,607	24,223,783
Accumulated deficit	(29,278,830)	(28,916,632)
Total stockholders' deficit	<u>(4,970,022)</u>	<u>(4,638,607)</u>
Total liabilities and stockholders' deficit	<u>\$ 785,279</u>	<u>\$ 917,456</u>

*The accompanying notes are an integral part of these unaudited financial statements*

**DAYBREAK OIL AND GAS, INC.**  
**Statements of Operations – Unaudited**

	For the Three Months Ended August 31,		For the Six Months Ended August 31,	
	2020	2019	2020	2019
<b>REVENUE:</b>				
Crude oil sales	\$ 108,564	\$ 163,055	\$ 177,763	\$ 359,413
<b>OPERATING EXPENSES:</b>				
Production	43,442	45,826	82,637	89,543
Exploration and drilling (G&G)	—	16	—	114
Depreciation, depletion, and amortization (DD&A)	14,668	14,856	28,827	30,922
General and administrative	150,184	142,465	302,553	388,433
Total operating expenses	208,294	203,163	414,017	509,012
OPERATING LOSS	(99,730)	(40,108)	(236,254)	(149,599)
<b>OTHER EXPENSE:</b>				
Interest expense, net	(65,471)	(118,841)	(125,944)	(272,935)
NET LOSS	(165,201)	(158,949)	(362,198)	(422,534)
Cumulative convertible preferred stock dividend requirement	(32,191)	(32,191)	(64,382)	(64,382)
NET LOSS AVAILABLE TO COMMON SHAREHOLDERS	\$ (197,392)	\$ (191,140)	\$ (426,580)	\$ (486,916)
NET LOSS PER COMMON SHARE, basic and diluted	\$ (0.00)	\$ (0.00)	\$ (0.01)	\$ (0.01)
<b>WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING</b>				
Basic and diluted	57,290,093	53,532,364	55,411,229	52,872,364

*The accompanying notes are an integral part of these unaudited financial statements*

**DAYBREAK OIL AND GAS, INC.**  
**Statements of Changes in Stockholders' Deficit**  
**For the Three Months and Six Months Ended August 31, 2020 and 2019**

	Series A Convertible Preferred Stock		Common Stock		Additional Paid-In Capital	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount			
BALANCE, FEBRUARY 29, 2020	709,568	\$ 710	53,532,364	\$ 53,532	\$ 24,223,783	\$ (28,916,632)	\$ (4,638,607)
<i>Recognition of warrants issued for:</i>							
Investor relations services	—	—	—	—	1,474	—	1,474
Net loss	—	—	—	—	—	(196,997)	(196,997)
BALANCE, MAY 31, 2020	<u>709,568</u>	<u>710</u>	<u>53,532,364</u>	<u>53,532</u>	<u>24,225,257</u>	<u>(29,113,629)</u>	<u>(4,834,130)</u>
<i>Issuance of common stock for:</i>							
Conversion of related party note payable	—	—	6,958,758	6,959	20,876	—	27,835
<i>Recognition of warrants issued for:</i>							
Investor relations services	—	—	—	—	1,474	—	1,474
Net loss	—	—	—	—	—	(165,201)	(165,201)
BALANCE, AUGUST 31, 2020	<u>709,568</u>	<u>\$ 710</u>	<u>60,491,122</u>	<u>\$ 60,491</u>	<u>\$ 24,247,607</u>	<u>\$ (29,278,830)</u>	<u>\$ (4,970,022)</u>

	Series A Convertible Preferred Stock		Common Stock		Additional Paid-In Capital	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount			
BALANCE, FEBRUARY 28, 2019	709,568	\$ 710	51,532,364	\$ 51,532	\$ 22,997,759	\$ (28,161,988)	\$ (5,111,987)
<i>Issuance of common stock for:</i>							
Accounts payable settlement	—	—	2,000,000	2,000	4,000	—	6,000
Net loss	—	—	—	—	—	(263,585)	(263,585)
BALANCE, MAY 31, 2019	<u>709,568</u>	<u>710</u>	<u>53,532,364</u>	<u>53,532</u>	<u>23,001,759</u>	<u>(28,425,573)</u>	<u>(5,369,572)</u>
Forgiveness of liabilities to related parties	—	—	—	—	1,215,145	—	1,215,145
Net loss	—	—	—	—	—	(158,949)	(158,949)
BALANCE, AUGUST 31, 2019	<u>709,568</u>	<u>\$ 710</u>	<u>53,532,364</u>	<u>\$ 53,532</u>	<u>\$ 24,216,904</u>	<u>\$ (28,584,522)</u>	<u>\$ (4,313,376)</u>

*The accompanying notes are an integral part of these unaudited financial statements*

**DAYBREAK OIL AND GAS, INC.**  
**Statements of Cash Flows – Unaudited**

	Six Months Ended	
	August 31, 2020	August 31, 2019
<i>CASH FLOWS FROM OPERATING ACTIVITIES:</i>		
Net loss	\$ (362,198)	\$ (422,534)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation, depletion, amortization and impairment expense	28,827	30,922
Amortization of debt discount	66,652	215,129
Operating lease expense in conjunction with right of use asset	4,393	3,698
Warrant issued for investor relations services	2,948	—
Changes in assets and liabilities:		
Accounts receivable – crude oil sales	(5,508)	(19,272)
Accounts receivable - joint interest participants	(2,295)	7,231
Prepaid expenses and other current assets	34,826	12,671
Accounts payable and other accrued liabilities	97,096	24,730
Accounts payable - related parties	15,072	74,491
Operating lease liability in conjunction with right of use asset	(4,393)	(3,698)
Accrued interest	39,658	40,739
Net cash used in operating activities	<u>(84,922)</u>	<u>(35,893)</u>
<i>CASH FLOWS FROM FINANCING ACTIVITIES:</i>		
Additions to line of credit	—	49,000
Proceeds from paycheck protection program (PPP) loan	74,355	—
Insurance financing repayments	(34,375)	—
Payments on line of credit	(30,000)	(30,000)
Net cash provided by financing activities	<u>9,980</u>	<u>19,000</u>
<i>NET DECREASE IN CASH AND CASH EQUIVALENTS</i>	(74,942)	(16,893)
<i>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</i>	94,043	30,078
<i>CASH AND CASH EQUIVALENTS AT END OF PERIOD</i>	<u>\$ 19,101</u>	<u>\$ 13,185</u>
<i>CASH PAID FOR:</i>		
Interest	\$ 4,542	\$ 16,702
Income taxes	\$ —	\$ —
<i>SUPPLEMENTAL CASH FLOW INFORMATION:</i>		
Unpaid additions to crude oil properties	\$ 1,054	\$ 210
Non-cash increase to line of credit due to monthly interest	\$ 14,706	\$ 15,684
Operating lease – right of use asset and associated liabilities	\$ —	\$ 13,787
Forgiveness of liabilities to related parties	\$ —	\$ 1,215,145
Settlement of related party debt with production revenue interest	\$ —	\$ 250,100
Common stock issued for settlement of related party note payable	\$ 27,835	\$ —
Common stock issued for settlement of accounts payable	\$ —	\$ 6,000

*The accompanying notes are an integral part of these unaudited financial statements*

**DAYBREAK OIL AND GAS, INC.**  
**NOTES TO UNAUDITED FINANCIAL STATEMENTS**

**NOTE 1 — ORGANIZATION AND BASIS OF PRESENTATION:**

*Organization*

Originally incorporated as Daybreak Uranium, Inc., (“Daybreak Uranium”) under the laws of the State of Washington on March 11, 1955, Daybreak Uranium was organized to explore for, acquire, and develop mineral properties in the Western United States. In August 1955, the assets of Morning Sun Uranium, Inc. were acquired by Daybreak Uranium. In May 1964, Daybreak Uranium changed its name to Daybreak Mines, Inc. During 2005, management of the Company decided to enter the crude oil exploration and production industry. On October 25, 2005, the Company shareholders approved a name change from Daybreak Mines, Inc. to Daybreak Oil and Gas, Inc. (referred to herein as “Daybreak” or the “Company”) to better reflect the business of the Company.

All of the Company’s crude oil production is sold under contracts which are market-sensitive. Accordingly, the Company’s financial condition, results of operations, and capital resources are highly dependent upon prevailing market prices of, and demand for, crude oil. These commodity prices are subject to wide fluctuations and market uncertainties due to a variety of factors that are beyond the control of the Company. These factors include the level of global demand for petroleum products, foreign supply of crude oil, the establishment of and compliance with production quotas by crude oil-exporting countries, the relative strength of the U.S. dollar, weather conditions, the price and availability of alternative fuels, and overall economic conditions, both foreign and domestic, crude oil disputes between Russia and Saudi Arabia; and national and international pandemics like the coronavirus outbreak.

*Basis of Presentation*

The accompanying unaudited interim financial statements and notes for the Company have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q for quarterly reports under Section 13 or 15(d) of the Securities Exchange Act of 1934 (the “Exchange Act”). Accordingly, they do not include all of the information and footnote disclosures normally required by accounting principles generally accepted in the United States of America for complete financial statements.

In the opinion of management, all adjustments considered necessary for a fair presentation of the financial statements have been included and such adjustments are of a normal recurring nature. Operating results for the six months ended August 31, 2020 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2021.

These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended February 29, 2020.

*Use of Estimates*

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions. These estimates and assumptions may affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the reporting period. Actual results could differ materially from those estimates. The accounting policies most affected by management’s estimates and assumptions are as follows:

- The reliance on estimates of proved reserves to compute the provision for depreciation, depletion and amortization (“DD&A”) and to determine the amount of any impairment of proved properties;
- The valuation of unproved acreage and proved crude oil properties to determine the amount of any impairment of crude oil properties;
- Judgment regarding the productive status of in-progress exploratory wells to determine the amount of any provision for abandonment; and
- Estimates regarding abandonment obligations; and
- Estimates regarding projected cash flows used in determining the production payable discount.

## *Earnings per Share*

The Company follows ASC Topic 260, *Earnings per Share*, to account for the earnings per share. Basic earnings per common share (“EPS”) calculations are determined by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per common share calculations are determined by dividing net income (loss) by the weighted average number of common shares and dilutive common share equivalents outstanding. During periods when common stock equivalents, if any, are anti-dilutive they are not considered in the computation.

## **NOTE 2 — GOING CONCERN:**

### *Financial Condition*

The Company’s financial statements for the six months ended August 31, 2020 have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities in the normal course of business. The Company has incurred net operating losses since entering the crude oil exploration industry and as of August 31, 2020 has an accumulated deficit of \$29.3 million and a working capital deficit of \$4.1 million which raises substantial doubt about the Company’s ability to continue as a going concern.

### *Management Plans to Continue as a Going Concern*

The Company continues to implement plans to enhance its ability to continue as a going concern. Daybreak currently has a net revenue interest (“NRI”) in 20 producing crude oil wells in its East Slopes Project located in Kern County, California (the “East Slopes Project”). The revenue from these wells has created a steady and reliable source of income for the Company. The Company’s average working interest (“WI”) in these wells is 36.6% and the average net revenue interest (“NRI”) is 28.4% for these same wells.

In December 2019, the 2019 novel coronavirus (“COVID-19”) surfaced in Wuhan, China. The World Health Organization declared a global emergency on January 30, 2020, with respect to the outbreak and several countries, including the United States, Japan and Australia have initiated travel restrictions to and from China. The impacts of the outbreak are unknown and rapidly evolving. This widespread health crisis and the governmental restrictions associated with it, have adversely affected demand for crude oil, depressed crude oil prices, and affected our ability to access capital. These factors, in turn, have had a negative impact on our operations, and financial condition as evidenced by the unprecedented decline in crude oil prices and our revenues during this same time period.

On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act commonly referred to as the CARES Act. One component of the CARES Act was the paycheck protection program (“PPP”) which provides small business with the resources needed to maintain their payroll and cover applicable overhead. The PPP is implemented by the Small Business Administration (“SBA”) with support from the Department of the Treasury. The PPP provides funds to pay up to eight weeks of payroll costs including benefits. Funds can also be used to pay interest on mortgages, rent, and utilities. The Company applied for, and was accepted to participate in this program. On May 11, 2020, the Company received funding for approximately \$74,355. We plan on participating in any future plans that become available to help businesses deal with the negative impact of this outbreak.

The Company anticipates its revenue will continue to increase as the Company participates in the drilling of more wells in the East Slopes Project in California and as our exploratory drilling project begins in Michigan. However, given the current volatility and instability in hydrocarbon prices, the timing of any drilling activity in California and Michigan will be dependent on a sustained improvement in hydrocarbon prices and a success in securing financing for its drilling programs.

The Company believes that its liquidity will improve when there is a sustained improvement in hydrocarbon prices. Daybreak’s sources of funds in the past have included the debt or equity markets and the sale of assets. It will be necessary for the Company to obtain additional funding from the private or public debt or equity markets in the future. However, the Company cannot offer any assurance that it will be successful in executing the aforementioned plans to continue as a going concern.

Daybreak’s financial statements as of August 31, 2020 do not include any adjustments that might result from the inability to implement or execute the Company’s plans to improve its ability to continue as a going concern.

**NOTE 3 — CONCENTRATION RISK:**

Substantially all of the Company's trade accounts receivable consists of receivables from the sale of crude oil production from operations by the Company and receivables from the Company's working interest partners in crude oil projects in which the Company acts as Operator of the project. This concentration of customers and joint interest owners may impact the Company's overall credit risk, as these entities could be affected by similar changes in economic conditions including lower crude oil prices as well as other related factors. Trade accounts receivable are generally not collateralized.

At the Company's East Slopes project in California, there is only one buyer for the purchase of crude oil production. The Company has no natural gas production in California. At August 31, 2020 and February 29, 2020 this one customer represented 100.0% of crude oil sales receivable. If this buyer is unable to resell its products or if they lose a significant sales contract, the Company may incur difficulties in selling its crude oil production.

Crude oil sales receivables balances of \$62,418 and \$56,910 at August 31, 2020 and February 29, 2020, were from one customer, Plains Marketing; and represent crude oil sales that occurred in August and February 2020, respectively.

Joint interest participant receivables balances of \$40,661 and \$38,366 at August 31, 2020 and February 29, 2020, respectively, represent amounts due from working interest partners in California, where the Company is the Operator. There were no allowances for doubtful accounts for the Company's trade accounts receivable at August 31, 2020 and February 29, 2020, as the joint interest owners have a history of paying their obligations.

**NOTE 4 — CRUDE OIL PROPERTIES:**

Crude oil property balances at August 31, 2020 and February 29, 2020 are set forth in the table below.

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
Proved leasehold costs	\$ 115,119	\$ 115,119
Costs of wells and development	2,279,244	2,278,190
Capitalized exploratory well costs	1,341,494	1,341,494
Cost of proved crude oil properties	3,735,857	3,734,803
Accumulated depletion, depreciation, amortization and impairment	(3,162,941)	(3,136,068)
Proved crude oil properties, net	\$ 572,916	\$ 598,735
Michigan unproved crude oil properties	55,978	55,978
Total proved and unproved crude oil properties, net	<u>\$ 628,894</u>	<u>\$ 654,713</u>

**NOTE 5 — ACCOUNTS PAYABLE:**

On March 1, 2009, the Company became the operator for its East Slopes Project located in Kern County, California. Additionally, the Company then assumed certain original defaulting partners' approximate \$1.5 million liability representing a 25% working interest in the drilling and completion costs associated with the East Slopes Project four earning well program. The Company subsequently sold the same 25% working interest on June 11, 2009. Of the \$1.5 million liability, \$244,849 remains unpaid and is included in both the August 31, 2020 and February 29, 2020 accounts payable balances. Payments on this liability has been delayed until the Company's cash flow situation improves. On October 17, 2018, a working interest partner in California filed a UCC financing statement in regards to payables owed to the partner by the Company. At August 31, 2020 and February 29, 2020, the balance owed this working interest partner was \$94,246 and \$101,544, respectively, and is included in the approximate \$1.62 million and 1.56 million accounts payable balance at August 31, 2020 and February 29, 2020, respectively.

**NOTE 6 — ACCOUNTS PAYABLE- RELATED PARTIES:**

The August 31, 2020 and February 29, 2020 accounts payable – related parties balances of approximately \$0.93 million and \$0.92 million respectively, were comprised primarily of deferred salaries of one of the Company's Executive Officers and certain employees; directors' fees; expense reimbursements; and deferred interest payments on a 12% Subordinated Notes owed to the Company's Chairman, President and Chief Executive Officer. Payment of any other deferred items has been delayed until the Company's cash flow situation improves.

**NOTE 7 — SHORT-TERM AND LONG-TERM BORROWINGS:***Convertible Promissory Note Payable – Related Party*

During the twelve months ended February 29, 2020, the Company’s Chairman, President and Chief Executive Officer loaned the Company \$27,835 for general operating expenses under a Convertible Note Purchase Agreement. The Note had a maturity date of July 12, 2020 and carried no interest, fees or penalties. By the terms of the Convertible Note Purchase Agreement, Mr. Westmoreland had also agreed to loan up to an additional \$22,165 in funding for the Company, if and when agreed upon, but this additional amount was not ever loaned pursuant to the Note.

On July 12, 2020, the Convertible Promissory Note issued on January 14, 2020 matured. The Note was not repaid in full on or prior to the maturity date, so, pursuant to the terms of the conversion feature of the Convertible Promissory Note, the \$27,835 balance of the Convertible Note was automatically converted into the Company’s common stock shares on July 13, 2020. The conversion price was \$0.004 per share resulting in 6,958,758 shares being issued. The balance of the Note was \$-0- and \$27,835 at August 31, 2020 and February 29, 2020, respectively.

*12% Subordinated Notes*

The Company’s 12% Subordinated Notes (“the Notes”) issued pursuant to a January 2010 private placement offering to accredited investors, resulted in \$595,000 in gross proceeds (of which \$250,000 was from a related party) to the Company and accrue interest at 12% per annum, payable semi-annually on January 29th and July 29th. On January 29, 2015, the Company and 12 of the 13 holders of the Notes agreed to extend the maturity date of the Notes for an additional two years to January 29, 2017. Effective January 29, 2017, the maturity date of the Notes and the expiration date of the warrants that were issued in conjunction with the Notes were extended for an additional two years to January 29, 2019. The 980,000 warrants held by ten noteholders expired on January 29, 2019.

The Company has informed the Note holders that the payment of principal and final interest will be late and is subject to future financing being completed. The Notes principal of \$565,000 was payable in full at the amended maturity date of the Notes, and has not been paid. The terms of the Notes, state that should the Board of Directors decide that the payment of the principal and any unpaid interest would impair the financial condition or operations of the Company, the Company may then elect a mandatory conversion of the unpaid principal and interest into the Company’s common stock at a conversion rate equal to 75% of the average closing price of the Company’s common stock over the 20 consecutive trading days preceding December 31, 2018. As of August 31, 2020, no conversion of the unpaid principal and interest into the Company’s common stock has occurred. The accrued interest on the 12% Notes at August 31, 2020 and February 29, 2020 was \$306,421 and \$272,428, respectively. There was no unamortized debt discount remaining at August 31, 2020 and February 29, 2020, respectively.

12% Note balances at August 31, 2020 and February 29, 2020 are set forth in the table below:

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
12% Subordinated Notes	\$ 315,000	\$ 315,000
12% Subordinated Notes, related party	250,000	250,000
Total 12% Subordinated Note balance	<u>\$ 565,000</u>	<u>\$ 565,000</u>

12% Note balances – accrued interest at August 31, 2020 and February 29, 2020 are set forth in the table below:

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
Accrued interest 12% Subordinated Notes	\$ 78,914	\$ 59,962
Accrued interest 12% Subordinated Notes – related party	227,507	212,466
Total accrued interest 12% Subordinated Notes	<u>\$ 306,421</u>	<u>\$ 272,428</u>

The accrued interest owed on the 12% Subordinated Note to the related party is presented on the Company’s Balance Sheets under the caption *Accounts payable – related party* rather than under the caption *Accrued interest*.

*Production Revenue Payable*

Since December 2018, the Company has been conducting a fundraising program to fund the drilling of future wells in California and Michigan and to settle some of its historical debt. The purchasers of production payment interests will receive a production revenue payment on future wells to be drilled in California and Michigan in exchange for their purchase. As of August 31, 2020, the production revenue payment program balance was \$950,100 of which \$550,100 was owed to a related party - the Company’s Chairman, President and Chief Executive Officer.

The production payment interest entitles the purchasers to receive production payments equal to twice their original amount paid, payable from a percentage of the Company's future net production payments from wells drilled after the date of the purchase and until the Production Payment Target (as described below) is met. The Company shall pay fifty percent of its net production payments from the relevant wells to the purchasers until each purchaser has received two times the purchase price (the "Production Payment Target"). Once the Company pays the purchasers amounts equal to the Production Payment Target, it shall thereafter pay a pro-rated eight percent (8%) of \$1.3 million on its net production payments from the relevant wells to each of the purchasers. However, if the total raised is less than the target \$1.3 million, then the payment will be a proportionate amount of the eight percent (8%). Additionally, if the Production Payment Target is not met within the first three years, the Company shall pay seventy-five percent of its production payments from the relevant wells to the purchasers until the Production Payment Target is met.

The Company accounted for the amounts received from these sales in accordance with ASC 470-10-25 and 470-10-35 which require amounts recorded as debt to be amortized under the interest method as described in ASC 835-30, Interest Method. Consequently, the program balance of \$950,100 has been recognized as a production revenue payable. The Company determined an effective interest rate based on future expected cash flows to be paid to the holders of the production payment interests. This rate represents the discount rate that equates estimated cash flows with the initial proceeds received from the sales and is used to compute the amount of interest to be recognized each period. Estimating the future cash outflows under this agreement requires the Company to make certain estimates and assumptions about future revenues and payments and such estimates are subject to significant variability. Therefore, the estimates are likely to change which may result in future adjustments to the accretion of the interest expense and the amortized cost based carrying value of the related payables.

Accordingly, the Company has estimated the cash flows associated with the production revenue payments and determined a discount of \$1,188,117 as of August 31, 2020, which is being accounted as interest expense over the estimated period over which payments will be made based on expected future revenue streams. For the six months ended August 31, 2020 and 2019, amortization of the debt discount on these payables amounted to \$66,652 and \$215,129, respectively, which has been included in interest expense in the statements of operations.

Production revenue payable balances at August 31, 2020 and February 29, 2020 are set forth in the table below:

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
Estimated payments of production revenue payable	\$ 2,138,217	\$ 2,054,766
Less: unamortized discount	(683,294)	(666,495)
	<u>1,454,923</u>	<u>1,388,271</u>
Less: current portion	(64,798)	(43,069)
Net production revenue payable – long-term	<u>\$ 1,390,125</u>	<u>\$ 1,345,202</u>

#### *Paycheck Protection Program (PPP) Loan*

On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act commonly referred to as the CARES Act. One component of the CARES Act was the paycheck protection program ("PPP") which provides small business with the resources needed to maintain their payroll and cover applicable overhead. The PPP is implemented by the Small Business Administration ("SBA") with support from the Department of the Treasury. The PPP provides funds to pay up to eight weeks of payroll costs including benefits. Funds can also be used to pay interest on mortgages, rent, and utilities. The Company applied for, and was accepted to participate in this program. On May 11, 2020, the Company received funding for approximately \$74,355.

The loan is a two-year loan with a maturity date of May 5, 2022. The loan bears an annual interest rate of 1%. The loan shall be payable monthly with the first six monthly payments deferred. It is the Company's intent to apply for loan forgiveness under the provisions of Section 1106 of the CARES Act. Loan forgiveness is subject to the sole approval of the SBA. The Company is eligible for loan forgiveness in an amount equal to payments made during the 8-week period beginning on the Loan date, with the exception that no more than 25.0% of the amount of loan forgiveness may be for expenses other than payroll expenses. The Company used all loan proceeds to partially subsidize direct payroll expenses.

#### *Line of Credit*

The Company has an existing \$890,000 line of credit for working capital purposes with UBS Bank USA ("UBS"), established pursuant to a Credit Line Agreement dated October 24, 2011 that is secured by the personal guarantee of its Chairman, President and Chief Executive Officer. On July 10, 2017, a \$700,000 portion of the outstanding line of credit balance was converted to a 24 month fixed term annual interest rate of 3.244% with interest payable monthly. On July 10, 2019, the 24-month fixed term loan amount of \$700,000 was renewed at the same annual percentage interest rate of 3.244% for an additional 24 months. The remaining principal

balance of the line of credit has a stated reference rate of 0.249% + 337.5 basis points with interest payable monthly. The reference rate is based on the 30 day LIBOR (“London Interbank Offered Rate”) and is subject to change from UBS.

During the six months ended August 31, 2020 and 2019, the Company received advances on the line of credit of \$-0- and \$49,000, respectively. During the six months ended August 31, 2020 and 2019, the Company made payments to the line of credit of \$30,000 and \$30,000, respectively. Interest converted to principal for the six months ended August 31, 2020 and 2019 was \$14,706 and \$15,684, respectively. At August 31, 2020 and February 29, 2020, the line of credit had an outstanding balance of \$857,107 and \$872,401, respectively.

#### *Note Payable*

In December 2018, the Company was able to settle an outstanding balance owed to one of its third-party vendors. This settlement resulted in a \$120,000 note payable issued to the vendor. Additionally, the Company agreed to issue 2,000,000 shares of the Company’s common stock as a part of the settlement agreement. Based on the closing price of the Company’s common stock on the date of the settlement agreement, the value of the common stock transaction was determined to be \$6,000. The common stock shares were issued during the twelve months ended February 29, 2020. The note has a maturity date of January 1, 2022 and bears an interest rate of 10% rate per annum. Monthly interest is accrued and payable on January 1<sup>st</sup> of each anniversary date through maturity of the note. At August 31, 2020, the note principal balance of \$120,000 and the accrued interest had not been paid and were outstanding. At August 31, 2020 and February 29, 2020, the accrued interest on the Note was \$20,000 and \$14,000, respectively.

#### *Encumbrances*

On October 17, 2018, a working interest partner in California filed a UCC financing statement in regards to payable amounts owed to the partner by the Company. As of August 31, 2020, we had no encumbrances on our crude oil project in Michigan.

#### **NOTE 8 — LEASES:**

The Company leases approximately 988 rentable square feet of office space from an unaffiliated third party for our corporate office located in Spokane Valley, Washington. Additionally, we lease approximately 416 and 695 rentable square feet from unaffiliated third parties for our regional operations office in Friendswood, Texas and storage and auxiliary office space in Wallace, Idaho, respectively. The lease in Friendswood is a 24 month lease that expires in October 2020. The Spokane Valley and Wallace leases are currently on a month-to-month basis. The Company’s lease agreements do not contain any residual value guarantees, restrictive covenants or variable lease payments. The Company has not entered into any financing leases.

The Company determines if an arrangement is a lease at inception. Operating leases are recorded in operating lease right of use assets, net, operating lease liability – current, and operating lease liability – long-term on its balance sheet.

Operating lease assets represent the Company’s right to use an underlying asset for the lease term and lease liabilities represent its obligation to make lease payments arising from the lease. Operating lease assets and liabilities are recognized at the commencement date based on the present value of lease payments over the lease term. As the Company’s leases do not provide an implicit rate, the Company uses its incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. The incremental borrowing rate used at adoption was 5.85%. Significant judgement is required when determining the Company’s incremental borrowing rate. Lease expense for lease payments is recognized on a straight-line basis over the lease term.

The Balance Sheet classification of lease assets and liabilities is as follows:

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
<b>Assets</b>		
Operating lease right-of use assets, beginning balance	\$ 5,857	\$ 13,787
Current period amortization	(4,393)	(7,930)
Total operating lease right-of-use asset	<u>1,464</u>	<u>5,857</u>
<b>Liabilities</b>		
Operating lease liability – current	1,464	5,857
Operating lease liability – long-term	—	—
Total lease liabilities	<u>\$ 1,464</u>	<u>\$ 5,857</u>

Future minimum lease payments as of August 31, 2020 under non-cancellable operating leases are as follows:

<u>Fiscal Year Ended</u>	<u>Annual Office Lease Obligation</u>
February 28, 2021	\$ 1,550
Total lease payments	1,550
Less: imputed interest	(86)
Operating lease liability	1,464
Less: operating lease liability – current	(1,464)
Operating lease liability, long-term	<u>\$ —</u>

Rent expense for the six months ended August 31, 2020 and 2019 was \$11,745, respectively.

**NOTE 9 — STOCKHOLDERS' DEFICIT:**

*Preferred Stock*

The Company is authorized to issue up to 10,000,000 shares of preferred stock with a par value of \$0.001. The Company's preferred stock may be entitled to preference over the common stock with respect to the distribution of assets of the Company in the event of liquidation, dissolution, or winding-up of the Company, whether voluntarily or involuntarily, or in the event of any other distribution of assets of the Company among its shareholders for the purpose of winding-up its affairs. The authorized but unissued shares of preferred stock may be divided into and issued in designated series from time to time by one or more resolutions adopted by the Board of Directors. The directors in their sole discretion shall have the power to determine the relative powers, preferences, and rights of each series of preferred stock.

*Series A Convertible Preferred Stock*

The Company has designated 2,400,000 shares of the 10,000,000 preferred shares as Series A Convertible Preferred Stock ("Series A Preferred"), with a \$0.001 par value. At August 31, 2020 and February 29, 2020, there were 709,568 shares issued and outstanding, respectively, that had not been converted into our common stock. As of August 31, 2020, there are 44 accredited investors who have converted 690,197 Series A Preferred shares into 2,070,591 shares of Daybreak common stock.

The conversions of Series A Preferred that have occurred since the Series A Preferred was first issued in July 2006 are set forth in the table below.

<u>Fiscal Period Ended</u>	<u>Shares of Series A Preferred Converted to Common Stock</u>	<u>Shares of Common Stock Issued from Conversion</u>	<u>Number of Accredited Investors</u>
Periods prior to February 29, 2014	662,200	1,986,600	41
February 28, 2015	3,000	9,000	1
February 29, 2016	10,000	30,000	1
February 28, 2017	—	—	—
February 28, 2018	14,997	44,991	1
February 28, 2019	—	—	—
February 29, 2020	—	—	—
August 31, 2020	—	—	—
Totals	<u>690,197</u>	<u>2,070,591</u>	<u>44</u>

Holders of Series A Preferred shall accrue dividends, in the amount of 6% of the original purchase price per annum. Dividends may be paid in cash or common stock at the discretion of the Company. Dividends are cumulative whether or not in any dividend period or periods the Company has assets legally available for the payment of such dividends. Accumulations of dividends on Series A Preferred do not bear interest. Dividends are payable upon declaration by the Board of Directors.

As of August 31, 2020 no dividends have been declared or paid. Dividends earned since issuance for each fiscal year and the six months ended August 31, 2020 are set forth in the table below:

Fiscal Period Ended	Shareholders at Period End	Accumulated Dividends
Periods prior to February 28, 2014		\$ 1,447,943
February 28, 2015	58	132,634
February 29, 2016	57	130,925
February 28, 2017	57	130,415
February 28, 2018	56	128,231
February 28, 2019	56	127,714
February 29, 2020	56	128,063
August 31, 2020	56	64,382
		<u>\$ 2,290,307</u>

#### *Common Stock*

The Company is authorized to issue up to 200,000,000 shares of \$0.001 par value common stock of which 60,491,122 and 53,532,364 shares were issued and outstanding as of August 31, 2020 and February 29, 2020, respectively.

	Common Stock Balance	Par Value
Common stock, Issued and Outstanding, February 28, 2019	51,532,364	
Issuance of common stock to settle accounts payable	2,000,000	\$ 2,000
Common stock, Issued and Outstanding, February 29, 2020	<u>53,532,364</u>	
Issuance of common stock to settle related party note payable	6,958,758	\$ 6,959
Common stock, Issued and Outstanding, August 31, 2020	<u>60,491,122</u>	

#### **NOTE 10 — WARRANTS:**

During the twelve months ended February 29, 2020 there were 2.1 million warrants issued to a third party for investor relations services. The fair value of the warrants was determined by the Black-Scholes pricing model, was \$17,689, and is being amortized over the three year vesting period of the warrants. The Black-Scholes valuation encompassed the following assumptions: a risk free interest rate of 1.68%; volatility rate of 260.23%; and a dividend yield of 0.0%.

The warrants contains a vesting blocking provision that prevents the vesting of any warrants that such vesting would cause the warrant holder's beneficial ownership (as such term is defined in Section 13d-3 of the Securities Exchange Act of 1934, as amended) to exceed more than four and ninety-nine one-hundredths percent (4.99%) of the Company's outstanding Common Stock. The foregoing restriction may not be waived by either party.

The warrants vest in equal parts over a three year period beginning on January 2, 2020 and all warrants expire on January 2, 2024. At August 31, 2020, both the outstanding warrants and the exercisable have a weighted average exercise price of \$0.01, a weighted average remaining life of 3.3 years, and an intrinsic value of -\$0-. For the six months ended August 31, 2020 and 2019, the recorded amount of warrant expense was \$2,948 and \$-0-, respectively.

Warrant activity for the six months ended August 31, 2020 is set forth in the table below:

	Warrants	Weighted Average Exercise Price
Warrants outstanding, February 29, 2020	2,100,000	\$ 0.01
Changes during the six months ended August 31, 2020:		
Issued	—	\$ —
Warrants outstanding, August 31, 2020	<u>2,100,000</u>	\$ 0.01
Warrants exercisable, August 31, 2020	<u>528,507</u>	\$ 0.01

**NOTE 11 — INCOME TAXES:**

On December 22, 2017, the federal government enacted a tax bill H.R.1, an act to provide for reconciliation pursuant to Titles II and V of the concurrent resolution on the budget for fiscal year 2018, commonly referred to as the Tax Cuts and Jobs Act. The Tax Cuts and Jobs Act contains significant changes to corporate taxation, including, but not limited to, reducing the U.S. federal corporate income tax rate from 35% to 21% and modifying or limiting many business deductions. The Company has re-measured its deferred tax liabilities based on rates at which they are expected to be utilized in the future, which is generally 21%.

Reconciliation between actual tax expense (benefit) and income taxes computed by applying the U.S. federal income tax rate and state income tax rates to income from continuing operations before income taxes is set forth in the table below:

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
Computed at U.S. and state statutory rates	\$ (108,080)	\$ (225,186)
Permanent differences	21,480	111,854
Changes in valuation allowance	86,600	113,332
Total	<u>\$ —</u>	<u>\$ —</u>

Tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred liabilities are set forth in the table below:

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
Deferred tax assets:		
Net operating loss carryforwards	\$ 5,542,791	\$ 5,463,014
Crude oil properties	57,145	50,322
Stock based compensation	66,187	66,187
Other	27,838	27,838
Less valuation allowance	(5,693,961)	(5,607,361)
Total	<u>\$ —</u>	<u>\$ —</u>

At August 31, 2020, the Company had estimated net operating loss (“NOL”) carryforwards for federal and state income tax purposes of approximately \$18,575,039 which will begin to expire, if unused, beginning in 2024. Under the Tax Cuts and Jobs Act, the NOL portion of the loss incurred in the 2018 period of \$340,749; the loss incurred for the year ended February 29, 2020 of \$339,299 and the loss incurred for the six months ended August 31, 2020 in the amount of \$267,351 will not expire and will carry over indefinitely. The valuation allowance increased \$86,600 for the six months ended August 31, 2020 and increased approximately \$113,332 for the year ended February 29, 2020, respectively. Section 382 of the Internal Revenue Code places annual limitations on the Company’s net operating loss (NOL) carryforward.

The above estimates are based on management’s decisions concerning elections which could change the relationship between net income and taxable income. Management decisions are made annually and could cause estimates to vary significantly. The Company files federal income tax returns with the United States Internal Revenue Service and state income tax returns in various state tax jurisdictions. As a general rule the Company’s tax returns for the fiscal years after 2015 currently remain subject to examinations by appropriate tax authorities. None of our tax returns are under examination at this time.

**NOTE 12 — COMMITMENTS AND CONTINGENCIES:**

Various lawsuits, claims and other contingencies arise in the ordinary course of the Company’s business activities. While the ultimate outcome of any future contingency is not determinable at this time, management believes that any liability or loss resulting therefrom will not materially affect the financial position, results of operations or cash flows of the Company.

The Company, as an owner or lessee and operator of crude oil properties, is subject to various federal, state and local laws and regulations relating to discharge of materials into, and protection of, the environment. These laws and regulations may, among other things, impose liability on the lessee under a crude oil lease for the cost of pollution clean-up resulting from operations and subject the lessee to liability for pollution damages. In some instances, the Company may be directed to suspend or cease operations in the affected area. The Company maintains insurance coverage that is customary in the industry, although the Company is not fully insured against all environmental risks.

The Company is not aware of any environmental claims existing as of August 31, 2020. There can be no assurance, however, that current regulatory requirements will not change or that past non-compliance with environmental issues will not be discovered on the Company's crude oil properties.

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

The following discussion is management's assessment of the current and historical financial and operating results of the Company and of our financial condition. It is intended to provide information relevant to an understanding of our financial condition, changes in our financial condition and our results of operations and cash flows and should be read in conjunction with our unaudited financial statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q for the six months ended August 31, 2020 and in our Annual Report on Form 10-K for the year ended February 29, 2020. References to "Daybreak", the "Company", "we", "us" or "our" mean Daybreak Oil and Gas, Inc.

### Cautionary Statement Regarding Forward-Looking Statements

Certain statements contained in our Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") 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 Exchange Act.

All statements other than statements of historical fact contained in this MD&A report are inherently uncertain and are forward-looking statements. Statements that relate to results or developments that we anticipate will or may occur in the future 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, without limitation, statements about the following:

- Our future operating results;
- Our future capital expenditures;
- Our future financing;
- Our expansion and growth of operations; and
- Our future investments in and acquisitions of crude oil 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. Important factors that could cause actual results to differ materially from our expectations include, but are not limited to, the following risks and uncertainties:

- General economic and business conditions;
- National and international pandemics such as the novel coronavirus COVID-19 outbreak;
- Exposure to market risks in our financial instruments;
- Fluctuations in worldwide prices and demand for crude oil;
- Our ability to find, acquire and develop crude oil properties;
- Fluctuations in the levels of our crude oil exploration and development activities;
- Risks associated with crude oil exploration and development activities;
- Competition for raw materials and customers in the crude oil industry;
- Technological changes and developments in the crude oil industry;
- Legislative and regulatory uncertainties, including proposed changes to federal tax law and climate change legislation, regulation of hydraulic fracturing and potential environmental liabilities;
- Our ability to continue as a going concern;
- Our ability to secure financing under any commitments as well as additional capital to fund operations; and
- Other factors discussed elsewhere in this Form 10-Q; in our other public filings and press releases; and discussions with Company management.

Our reserve estimates are determined through a subjective process and are subject to revision.

In December 2019, the 2019 novel coronavirus ("COVID-19") surfaced in Wuhan, China. The World Health Organization declared a global emergency on January 30, 2020, with respect to the outbreak and several countries, including the United States, Japan and Australia have initiated travel restrictions to and from China. The full economic impact of the outbreak is unknown and rapidly evolving. This widespread health crisis and the governmental restrictions associated with it, have adversely affected demand for crude oil and natural gas, depressed crude oil prices, and affected our ability to access capital. These factors, in turn, have had a negative impact on our operations, and financial condition as evidenced by the unprecedented decline in crude oil prices and our revenues during this same time period.

Should one or more of the risks or uncertainties described above or elsewhere in our Form 10-K for the year ended February 29, 2020 and in this Form 10-Q for the six months ended August 31, 2020 occur, or should any underlying assumptions prove incorrect, our actual results and plans could differ materially from those expressed in any forward-looking statements. We specifically undertake no obligation to publicly update or revise any information contained in any forward-looking statement or any forward-looking statement in its entirety, whether as a result of new information, future events, or otherwise, except as required by law.

All forward-looking statements attributable to us are expressly qualified in their entirety by this cautionary statement.

## **Introduction and Overview**

We are an independent crude oil exploration, development and production company. Our basic business model is to increase shareholder value by finding and developing crude oil reserves through exploration and development activities, and selling the production from those reserves at a profit. To be successful, we must, over time, be able to find crude oil reserves and then sell the resulting production at a price that is sufficient to cover our finding costs, operating expenses, administrative costs and interest expense, plus offer us a return on our capital investment. A secondary means of generating returns can include the sale of either producing or non-producing lease properties.

Our longer-term success depends on, among many other factors, the acquisition and drilling of commercial grade crude oil properties and on the prevailing sales prices for crude oil along with associated operating expenses. The volatile nature of the energy markets makes it difficult to estimate future prices of crude oil and natural gas; however, any prolonged period of depressed prices or market volatility, would have a material adverse effect on our results of operations and financial condition.

Our operations are focused on identifying and evaluating prospective crude oil properties and funding projects that we believe have the potential to produce crude oil or natural gas in commercial quantities. We conduct all of our drilling, exploration and production activities in the United States, and all of our revenues are derived from sales to customers within the United States. Currently, we are in the process of developing a multi-well oilfield project in Kern County, California and an exploratory joint drilling project in Michigan.

Our management cannot provide any assurances that Daybreak will ever operate profitably. While we have positive cash flow from our crude oil operations in California, we have not yet generated sustainable positive cash flow or earnings on a company-wide basis. As a small company, we are more susceptible to the numerous business, investment and industry risks that have been described in Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended February 29, 2020 and in Part III, Item 1A. Risk Factors of this 10-Q Report. Throughout this Quarterly Report on Form 10-Q, crude oil is shown in barrels (“Bbls”); natural gas is shown in thousands of cubic feet (“Mcf”) unless otherwise specified, and hydrocarbon totals are expressed in barrels of crude oil equivalent (“BOE”).

Below is brief summary of our crude oil projects in California and Michigan. Refer to our discussion in Item 2. Properties, in our Annual Report on Form 10-K for the year ended February 29, 2020 for more information on our multi-well oilfield project in California and our exploratory joint drilling project in Michigan.

### **Kern County, California (East Slopes Project)**

The East Slopes Project is located in the southeastern part of the San Joaquin Basin near Bakersfield, California. Drilling targets are porous and permeable sandstone reservoirs that exist at depths of 1,200 feet to 4,500 feet. Since January 2009, we have participated in the drilling of 25 wells in this project. We have been the Operator at the East Slopes Project since March 2009.

The crude oil produced from our acreage in the Vedder Sand is considered heavy oil. The gravity of the crude oil ranges from 14<sup>°</sup> to 16<sup>°</sup> API (American Petroleum Institute) gravity and must be heated to separate and remove water prior to sale. Our crude oil wells in the East Slopes Project produce from five reservoirs at our Sunday, Bear, Black, Ball and Dyer Creek locations. The Sunday property has six producing wells, while the Bear property has nine producing wells. The Black property is the smallest of all currently producing reservoirs, and currently has two producing wells at this property. The Ball property also has two producing wells while the Dyer Creek property has one producing well. During the six months ended August 31, 2020 we had production from 20 vertical crude oil wells. Our average working interest (“WI”) and net revenue interest (“NRI”) in these 20 wells is 36.6% and 28.4%, respectively.

When funding is available, we plan on acquiring additional acreage exhibiting the same seismic characteristics and on trend with the Bear, Black and Dyer Creek reservoirs. Some of these prospects, if successful, would utilize the Company’s existing production facilities. In addition to the current field development, there are several other exploratory prospects that have been identified from the seismic data, which we plan to drill in the future.

## California Drilling Plans

Planned drilling activity and implementation of our oilfield development plan will not begin until financing is put in place. We do not plan to make any capital investments within the East Slopes Project area in the 2020-2021 fiscal year if no new financing is in place. If new financing is secured, we plan to spend approximately \$525,000 drilling four development wells in the 2020-2021 fiscal year.

### Michigan Acreage Acquisition

In January 2017, Daybreak acquired a 30% working interest in 1,400 acres in the Michigan Basin. The leases have been secured and multiple targets were identified through a 2-D seismic interpretation. A 3-D seismic survey was obtained in January and February of 2017. An analysis of the 3-D seismic survey confirmed the first prospect originally identified on the 2-D seismic, as well as several additional drilling locations. We have plans to obtain an additional 3-D survey on the second prospect after drilling a well on the first prospect. The two prospects are independent of each other and the success or lack of results of either prospect does not affect the potential of the other prospect. The wells will be drilled vertically with conventional completions and no hydraulic fracturing is anticipated. With the settlement of our debt obligations to a former lender in December 2018, we acquired an additional 40% working interest, bringing our aggregate working interest to 70% in Michigan. The first well is expected to be drilled in the spring of 2021 if new financing is secured.

### Encumbrances

On October 17, 2018, a working interest partner in California filed a UCC financing statement in regards to payables owed to the partner by the Company. As of August 31, 2020, we had no encumbrances on our crude oil project in Michigan.

### Results of Operations – Six months ended August 31, 2020 compared to the six months ended August 31, 2019

#### California Crude Oil Prices

The price we receive for crude oil sales in California is based on prices posted for Midway-Sunset crude oil delivery contracts, less deductions that vary by grade of crude oil sold and transportation costs. The posted Midway-Sunset price generally moves in correlation to, and at a discount to, prices quoted on the New York Mercantile Exchange (“NYMEX”) for spot West Texas Intermediate (“WTI”) crude oil, Cushing, Oklahoma delivery contracts. We do not have any natural gas revenues in California.

There has been a significant amount of volatility in crude oil prices and a dramatic decline in our realized sale price of crude oil since June of 2014, when the monthly average price of WTI crude oil was \$105.79 per barrel and our realized price per barrel of crude oil was \$98.78. This volatility and decline in crude oil prices has continued as evidenced by the NYMEX daily closing price of WTI crude oil on April 20, 2020 when it closed at a negative \$36.98; the April 2020 monthly average WTI price was \$16.55; and our monthly realized price for April 2020 was \$16.96 per barrel. This volatility and decline in the price of crude oil has had a substantial negative impact on our cash flow from our producing California properties. While there has been some improvement in crude oil prices since April 2020, there is no guarantee that this trend will continue.

It is beyond our ability to accurately predict how long crude oil prices will continue to remain at these lower price levels; when or at what level they may begin to stabilize; or when they may rebound to 2014 levels, as there are many factors beyond our control that dictate the price we receive on our crude oil sales.

A comparison of the average WTI price and average realized crude oil sales price for the six months ended August 31, 2020 and 2019 is shown in the table below:

	Six Months Ended		Percentage Change
	August 31, 2020	August 31, 2019	
Average six month WTI crude oil price (Bbl)	\$ 32.61	\$ 58.28	(44.0%)
Average six month realized crude oil sales price (Bbl)	\$ 30.68	\$ 61.98	(50.5%)

For the six months ended August 31, 2020, the average WTI price was \$32.61 and our average realized crude oil sale price was \$30.68, representing a discount of \$1.93 per barrel or 5.9% lower than the average WTI price. In comparison, for the six months ended August 31, 2019, the average WTI price was \$58.28 and our average realized sale price was \$61.98 representing a premium of \$3.70 per barrel or 6.3% higher than the average WTI price. Historically, the sale price we receive for California heavy crude oil has been less than the quoted WTI price because of the lower API gravity of our California crude oil in comparison to the API gravity of quoted WTI crude oil.

## California Crude Oil Revenue and Production

Crude oil revenue in California for the six months ended August 31, 2020 decreased \$181,650 or 50.5% to \$177,763 in comparison to revenue of \$359,413 for the six months ended August 31, 2019. The average sale price of a barrel of crude oil for the six months ended August 31, 2020 was \$30.68 in comparison to \$61.98 for the six months ended August 31, 2019. The decrease of \$31.30 or 50.5% per barrel in the average realized price of a barrel of crude oil accounted for 99.9% of the decrease in crude oil revenue for the six months ended August 31, 2020. The 2019 novel coronavirus (“COVID-19”) that has spread to countries throughout the world including the United States has had a substantial negative impact on the demand for crude oil and is largely responsible for the decline in crude oil prices.

Our net sales volume for the six months ended August 31, 2020 was 5,794 barrels of crude oil in comparison to 5,799 barrels sold for the six months ended August 31, 2019. This decrease in crude oil sales volume of five barrels or 0.1% was primarily due to the natural decline in reservoir pressure during the six months ended August 31, 2020.

The gravity of our produced crude oil in California ranges between 14 API and 16 API. Production for the six months ended August 31, 2020 was from 20 wells resulting in 3,675 well days of production in comparison to 3,630 well days of production for the six months ended August 31, 2019.

Our crude oil sales revenue for the six months ended August 31, 2020 and 2019 is set forth in the following table:

Project	Six Months Ended August 31, 2020		Six Months Ended August 31, 2019	
	Revenue	Percentage	Revenue	Percentage
California – East Slopes Project	\$ 177,763	100.0%	\$ 359,413	100.0%

\*Our average realized sale price on a BOE basis for the six months ended August 31, 2020 was \$30.68 in comparison to \$61.98 for the six months ended August 31, 2019, representing a decrease of \$31.30 or 50.5% per barrel.

## Operating Expenses

Total operating expenses for the six months ended August 31, 2020 were \$414,017, a decrease of \$94,995 or 18.7% compared to \$509,012 for the six months ended August 31, 2019. Operating expenses for the six months ended August 31, 2020 and 2019 are set forth in the table below:

	Six Months Ended August 31, 2020			Six Months Ended August 31, 2019		
	Expenses	Percentage	BOE Basis	Expenses	Percentage	BOE Basis
Production expenses	\$ 82,637	20.0%		\$ 89,543	17.6%	
Exploration and drilling expenses	—	0.0%		114	0.0%	
Depreciation, depletion, amortization (“DD&A”)	28,827	7.0%		30,922	6.1%	
General and administrative (“G&A”) expenses	302,553	73.0%		388,433	76.3%	
Total operating expenses	\$ 414,017	100.0%	\$ 71.46	\$ 509,012	100.0%	\$ 87.78

Production expenses include expenses associated with the production of crude oil. These expenses include contract pumpers, electricity, road maintenance, control of well insurance, property taxes and well workover expenses; and, relate directly to the number of wells that are in production. For the six months ended August 31, 2020, these expenses decreased by \$6,906 or 7.7% to \$82,637 in comparison to \$89,543 for the six months ended August 31, 2019. For the six months ended August 31, 2020 and 2019, we had 20 wells on production in California. Production expense on a barrel of oil equivalent (“BOE”) basis for the six months ended August 31, 2020 and 2019 was \$14.26 and \$15.44, respectively. Production expenses represented 20.0% and 17.6% of total operating expenses for the six months ended August 31, 2020 and 2019, respectively.

Exploration and drilling expenses include geological and geophysical (“G&G”) expenses as well as leasehold maintenance, plugging and abandonment (“P&A”) expenses and dry hole expenses. For the six months ended August 31, 2020, these expenses decreased \$114 to \$0- in comparison to \$114 the six months ended August 31, 2019. Exploration and drilling expenses represented 0.0% and 0.0% of total operating expenses for the six months ended August 31, 2020 and 2019, respectively.

Depreciation, depletion and amortization (“DD&A”) expenses relate to equipment, proven reserves and property costs, along with impairment, and is another component of operating expenses. For the six months ended August 31, 2020, DD&A expenses decreased \$2,095 or 6.8% to \$28,827 in comparison to \$30,922 for the six months ended August 31, 2019. On a BOE basis, DD&A expense was \$4.98 and \$5.33 for the six months ended August 31, 2020 and 2019, respectively. DD&A expenses represented 7.0% and 6.1% of total operating expenses for the six months ended August 31, 2020 and 2019, respectively.

General and administrative (“G&A”) expenses include the salaries of our six full-time employees, including management. During the first three months of the prior fiscal year ended February 29, 2020, fifty percent (50%) of certain management salaries were being deferred by the Company. However, effective June 1, 2019, the salary deferral program ended and those base salaries were temporarily reduced by half, to the amount currently being paid. Additionally, director fees are being suspended temporarily. Both of these compensation changes were reviewed by the Board of Directors during June 2020 and based on the financial status of the Company it was decided to continue these temporary changes. Other items included in our G&A expenses are legal and accounting expenses, investor relations fees, travel expenses, insurance expenses and other administrative expenses necessary for an operator of crude oil properties as well as for running a public company. For the six months ended August 31, 2020, G&A expenses decreased \$85,880 or 22.1% to \$302,553 in comparison to \$388,433 for the six months ended August 31, 2019. We received, as Operator, administrative overhead reimbursement of \$26,644 during the six months ended August 31, 2020 for the East Slopes Project which was used to directly offset certain employee salaries. We are continuing a program of controlling our G&A costs wherever possible. G&A expenses represented 73.0% and 76.3% of total operating expenses for the six months ended August 31, 2020 and 2019, respectively.

Interest expense, net for the six months ended August 31, 2020 decreased \$146,991 or 53.9% to \$125,944 in comparison to \$272,935 for the six months ended August 31, 2019.

### Results of Operations – Three months ended August 31, 2020 compared to the three months ended August 31, 2019

A comparison of the average WTI price and average realized crude oil sales price at our East Slopes Project in California for the three months ended August 31, 2020 and 2019 is shown in the table below:

	Three Months Ended		Percentage Change
	August 31, 2020	August 31, 2019	
Average three month WTI crude oil price (Bbl)	\$ 40.45	\$ 55.61	(27.3%)
Average three month realized crude oil sales price (Bbl)	\$ 36.86	\$ 58.78	(37.3%)

For the three months ended August 31, 2020, the average WTI price was \$40.45 and our average realized crude oil sale price was \$36.86, representing a discount of \$3.59 per barrel or 8.9% lower than the average WTI price. In comparison, for the three months ended August 31, 2019, the average WTI price was \$55.61 and our average realized sale price was \$58.78 representing a premium of \$3.17 per barrel or 5.7% higher than the average WTI price. Historically, the sale price we receive for California heavy crude oil has been less than the quoted WTI price because of the lower API gravity of our California crude oil in comparison to the API gravity of quoted WTI crude oil.

#### California Crude Oil Revenue and Production

Crude oil revenue in California for the three months ended August 31, 2020, decreased \$54,491 or 33.4% to \$108,564 in comparison to revenue of \$163,055 for the three months ended August 31, 2019. The average sale price of a barrel of crude oil for the three months ended August 31, 2020 was \$36.86 in comparison to \$58.78 for the three months ended August 31, 2019. The decrease of \$21.92 or 37.3% per barrel in the average realized price of a barrel of crude oil accounted for 100.0% of the decrease in crude oil revenue for the three months ended August 31, 2020.

Our net sales volume for the three months ended August 31, 2020 was 2,945 barrels of crude oil in comparison to 2,774 barrels sold for the three months ended August 31, 2019. This increase in crude oil sales volume of 171 barrels or 6.2% was not sufficient enough to offset the decrease in revenue due to lower crude oil prices for the three months ended August 31, 2020.

The gravity of our produced crude oil in California ranges between 14 API and 16 API. Production for the three months ended August 31, 2020 was from 20 wells resulting in 1,837 well days of production in comparison to 1,828 well days of production for the three months ended August 31, 2019.

Our crude oil sales revenue for the three months ended August 31, 2020 and 2019 is set forth in the following table:

Project	Three Months Ended August 31, 2020		Three Months Ended August 31, 2019	
	Revenue	Percentage	Revenue	Percentage
California – East Slopes Project	\$ 108,564	100.0%	\$ 163,055	100.0%

\*Our average realized sale price on a BOE basis for the three months ended August 31, 2020 was \$36.86 in comparison to \$58.78 for the three months ended August 31, 2019, representing a decrease of \$21.92 or 37.3% per barrel.

### Operating Expenses

Total operating expenses for the three months ended August 31, 2020 were \$208,294, an increase of \$5,131 or 2.5% compared to \$203,163 for the three months ended August 31, 2019. Operating expenses for the three months ended August 31, 2020 and 2019 are set forth in the table below:

	Three Months Ended August 31, 2020			Three Months Ended August 31, 2019		
	Expenses	Percentage	BOE Basis	Expenses	Percentage	BOE Basis
Production expenses	\$ 43,442	20.9%		\$ 45,826	22.6%	
Exploration and drilling expenses	—	0.0%		16	0.0%	
Depreciation, depletion, amortization (“DD&A”)	14,668	7.0%		14,856	7.3%	
General and administrative (“G&A”) expenses	150,184	72.1%		142,465	70.1%	
Total operating expenses	\$ 208,294	100.0%	\$ 70.73	\$ 203,163	100.0%	\$ 73.24

Production expenses for the three months ended August 31, 2020, decreased by \$2,384 or 5.2% to \$43,442 in comparison to \$45,286 for the three months ended August 31, 2019. For the three months ended August 31, 2020 and 2019 we had 20 wells on production in California. Production expense on a barrel of oil equivalent (“BOE”) basis for the three months ended August 31, 2020 and 2019 were \$14.75 and \$16.52, respectively. Production expenses represented 20.9% and 22.6% of total operating expenses for the three months ended August 31, 2020 and 2019, respectively.

Exploration and drilling expenses for the three months ended August 31, 2020, decreased \$16 to \$0- in comparison to \$16 for the three months ended August 31, 2019. Exploration and drilling expenses represented 0.0% and 0.0% of total operating expenses for the three months ended August 31, 2020 and 2019, respectively.

DD&A expenses for the three months ended August 31, 2020, decreased \$188 or 1.3% to \$14,668 in comparison to \$14,856 for the three months ended August 31, 2019. DD&A on a BOE basis was \$4.98 and \$5.36 for the three months ended August 31, 2020 and 2019, respectively. DD&A expenses represented 7.0% and 7.3% of total operating expenses for the three months ended August 31, 2020 and 2019, respectively.

G&A expenses for the three months ended August 31, 2020, increased \$7,719 or 5.4% to \$150,184 in comparison to \$142,465 for the three months ended August 31, 2019. Effective June 1, 2019, the salary deferral program that was in place ended and those base salaries were reduced by half, to the amount currently being paid. Additionally, director fees are being suspended temporarily. Both of these compensation changes were reviewed by the Board of Directors during June 2020 and based on the financial status of the Company it was decided to continue these temporary changes. Other items included in our G&A expenses are legal and accounting expenses, director fees, investor relations fees, travel expenses, insurance expenses and other administrative expenses necessary for an operator of crude oil properties as well as for running a public company. We received, as Operator in California, administrative overhead reimbursement of \$13,322 during the three months ended August 31, 2020 for the East Slopes Project which was used to directly offset certain employee salaries. We are continuing a program of reducing all of our G&A costs wherever possible. G&A expenses represented 72.1% and 70.1% of total operating expenses for the three months ended August 31, 2020 and 2019, respectively.

Interest expense, net for the three months ended August 31, 2020 decreased \$53,370 or 44.9% to \$65,471 in comparison to \$118,841 for the three months ended August 31, 2019.

Due to the nature of our business, we expect that revenues, as well as all categories of expenses, will continue to fluctuate substantially on a quarter-to-quarter and year-to-year basis. Revenues are highly dependent on the volatility of hydrocarbon prices and production volumes. Production expenses will fluctuate according to the number and percentage ownership of producing wells as well as the amount of revenues we receive based on the price of crude oil. Exploration and drilling expenses will be dependent upon the amount of capital that we have to invest in future development projects, as well as the success or failure of such projects. Likewise, the amount of DD&A expense will depend upon the factors cited above including the size of our proven reserves base and the market price of energy products. G&A expenses will also fluctuate based on our current requirements, but will generally tend to increase as we expand the business operations of the Company. An on-going goal of the Company is to improve cash flow to cover the current level of G&A expenses and to fund our drilling programs in California and Michigan.

### Capital Resources and Liquidity

Our primary financial resource is our proven crude oil reserve base. Our ability to fund any future capital expenditure programs is dependent upon the prices we receive from crude oil sales, the success of our drilling programs in California and Michigan and the availability of capital resource financing. There has been a significant amount of volatility in crude oil prices and dramatic decline in our realized sale price of crude oil since June of 2014, when the monthly average price of WTI crude oil was \$105.79 per barrel, and our realized sale price per barrel of crude oil was \$98.78. This volatility and decline in crude oil prices has continued as evidenced by the NYMEX daily closing price of WTI crude oil on April 20, 2020 when it closed at a negative \$36.98; the April 2020 monthly average WTI price was \$16.55; and our monthly realized price for April 2020 was \$16.96 per barrel. This volatility and decline in the price of crude oil has had a substantial negative impact on our cash flow from our producing California properties. While there has been some improvement in crude oil prices since April 2020, there is no guarantee that this trend will continue. Most recently our average realized price declined from \$61.98 for the six months ended August 31, 2019 to \$30.68 for the six months ended August 31, 2020, demonstrating the continued volatility in crude oil prices. It is beyond our ability to accurately predict how long crude oil prices will continue to remain at these lower price levels; when or at what level they may begin to stabilize; or when they may continue to rebound as there are many factors beyond our control that dictate the price we receive for our crude oil sales.

In the current fiscal year we plan to spend approximately \$525,000 in capital investments in California if new financing is secured. However, our actual expenditures may vary significantly from this estimate if our plans for exploration and development activities change during the year or if we are unable to obtain financing to fund these capital investments. Factors such as changes in operating margins and the availability of capital resources could increase or decrease our ultimate level of expenditures during the current fiscal year.

Changes in our capital resources at August 31, 2020 in comparison to February 29, 2020 are set forth in the table below:

	August 31, 2020	February 29, 2020	Increase (Decrease)	Percentage Change
Cash	\$ 19,101	\$ 94,043	\$ (74,942)	(79.7%)
Current Assets	\$ 138,469	\$ 240,434	\$ (101,965)	(42.4%)
Total Assets	\$ 785,279	\$ 917,456	\$ (132,177)	(14.4%)
Current Liabilities	\$ (4,216,073)	\$ (4,063,712)	\$ 152,361	3.7%
Total Liabilities	\$ (5,755,301)	\$ (5,556,063)	\$ 199,238	3.6%
Working Capital Deficit	\$ (4,077,604)	\$ (3,823,278)	\$ 254,326	6.7%

Our working capital deficit increased approximately \$0.25 million or 6.7% to approximately \$4.1 million at August 31, 2020 in comparison to approximately \$3.8 million at February 29, 2020. The increase in our working capital deficit was due to the settlement of accounts payable owed to related parties through a debt forgiveness program during 2019.

While we have ongoing positive cash flow from our crude oil operations in California, we have not yet been able to generate sufficient cash flow to cover all of our G&A and interest expense requirements. We anticipate an increase in our cash flow will occur when we are able to return to our planned drilling program that will result in an increase in the number of wells on production.

Our business is capital intensive. Our ability to grow is dependent upon favorably obtaining outside capital and generating cash flows from operating activities necessary to fund our investment activities. There is no assurance that we will be able to achieve profitability. Since our future operations will continue to be dependent on successful exploration and development activities and our ability to seek and secure capital from external sources, should we be unable to achieve sustainable profitability this could cause any equity investment in the Company to become worthless.

Major sources of funds in the past for us have included the debt or equity markets and the sale of assets. While we have positive cash flow from our operations in California, we will have to rely on the capital markets to fund future operations and growth. Our business model is focused on acquiring exploration or development properties as well as existing production. Our ability to generate future revenues and operating cash flow will depend on successful exploration, and/or acquisition of crude oil producing properties, which may very likely require us to continue to raise equity or debt capital from outside sources.

Daybreak 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 the right to participate in future drilling on certain leases or the loss of the lease itself. These ongoing capital commitments will cause us to seek additional forms of financing through various methods, including issuing debt securities, equity securities, bank debt, or combinations of these instruments which could result in dilution to existing security holders and increased debt and leverage. The current volatility in the credit and capital markets as well as the decline in crude oil prices from June of 2014 price levels has restricted our ability to obtain needed capital. No assurance can be given that we will be able to obtain funding under any loan commitments or any additional financing on favorable terms, if at all. The sale of all or part of interests in our assets may be another source of cash flow available to us.

The Company's financial statements for the six months ended August 31, 2020 have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities in the normal course of business. We have incurred net losses since entering the crude oil exploration industry in 2005, and as of the six months ended August 31, 2020, we have an accumulated deficit of \$29.3 million and a working capital deficit of \$4.1 million which raises substantial doubt about our ability to continue as a going concern.

In the current fiscal year, we will continue to seek additional financing for our planned exploration and development activities in California and Michigan. We could obtain financing through one or more various methods, including issuing debt securities, equity securities, or bank debt, or combinations of these instruments, which could result in dilution to existing security holders and increased debt and leverage. No assurance can be given that we will be able to obtain funding under any loan commitments or any additional financing on favorable terms, if at all. Sales of interests in our assets may be another source of cash flow.

### **Changes in Financial Condition**

During the six months ended August 31, 2020, we received crude oil sales revenue from 20 wells in California. Our commitment to improving corporate profitability remains unchanged. We experienced a decrease in revenues of \$181,650 or 50.5% to \$177,763 for the six months ended August 31, 2020 in comparison to revenues of \$359,413 for the six months ended August 31, 2019. The decrease of \$31.30 or 50.5% per barrel in the average realized price of a barrel of crude oil accounted for 99.9% of the decrease in crude oil revenue for the six months ended August 31, 2020. For the six months ended August 31, 2020, we had an operating loss of \$236,254 in comparison to an operating loss of \$149,599 for the six months ended August 31, 2019.

Our balance sheet at August 31, 2020 reflects total assets of approximately \$0.79 million in comparison to approximately \$0.92 million at February 29, 2020. The decrease of \$132,177 is primarily due to cash outflow from operations and depletion of our crude oil properties.

At August 31, 2020, total liabilities were approximately \$5.8 million in comparison to approximately \$5.6 million at February 29, 2020. The increase in liabilities of \$199,238 was primarily due to an increase in accounts payable and the paycheck protection program (PPP) loan.

The issued and outstanding shares of common stock at August 31, 2020 increased by 6,958,758 shares in comparison to the February 29, 2020 balance of 53,532,364 shares as a result of the conversion of a related party note payable. The common stock issuance was valued at \$27,835.

Additional paid in capital (APIC) increased \$23,824 to \$24,247,607 at August 31, 2020 from \$24,223,783 as a result of the conversion of a related party note payable.

## Cash Flows

Changes in the net funds provided by and (used in) our operating, investing and financing activities are set forth in the table below:

	Six Months Ended August 31, 2020	Six Months Ended August 31, 2019	Increase (Decrease)	Percentage Change
Net cash (used in) operating activities	\$ (84,922)	\$ (35,893)	49,029	136.6%
Net cash provided by (used in) investing activities	\$ —	\$ —	—	—
Net cash provided by financing activities	\$ 9,980	\$ 19,000	(9,020)	(47.5%)

### Cash Flow Used In Operating Activities

Cash flow from operating activities is derived from the production of our crude oil reserves and changes in the balances of non-cash accounts, receivables, payables or other non-energy property asset account balances. For the six months ended August 31, 2020, cash flow used in operating activities was \$84,922 in comparison to cash flow used in operating activities of \$35,893 for the six months ended August 31, 2019. The increase in our cash flow used in operating activities for the six months ended August 31, 2020 was due to a reduction in our non-cash operating expenses, an increase in our asset and liability balances and our net loss. Changes in non-cash account balances primarily relating to DD&A and amortization of debt discount. Variations in cash flow from operating activities may impact our level of exploration and development expenditures.

### Cash Flow Provided By (Used In) Investing Activities

Cash flow from investing activities is derived from changes in crude oil property balances and any lending activities. Cash flow used in our investing activities for the six months ended August 31, 2020 was \$-0- in comparison to cash flow used in our investing activities of \$-0- for the six months ended August 31, 2019.

### Cash Flow Provided By Financing Activities

Cash flow from financing activities is derived from changes in liability account balances or in equity account balances, excluding retained earnings. Cash flow provided by our financing activities was \$9,980 for the six months ended August 31, 2020 in comparison to cash flow provided by our financing activities of \$19,000 for the six months ended August 31, 2019. The decrease provided by our cash flow activities was primarily due to an additional cash advances received from our UBS line of credit during the six months ended August 31, 2019. For the six months ended August 31, 2020, we made total payments of \$30,000 to our line of credit with UBS Bank.

The following discussion is a summary of cash flows provided by, and used in, the Company's financing activities at August 31, 2020.

#### *Current debt (Short-term borrowings)*

##### *Convertible Promissory Note Payable – Related Party*

During the twelve months ended February 29, 2020, the Company's Chairman, President and Chief Executive Officer loaned the Company \$27,835 for general operating expenses under a Convertible Note Purchase Agreement. The Note had a maturity date of July 12, 2020 and carried no interest, fees or penalties. By the terms of the Convertible Note Purchase Agreement, Mr. Westmoreland had also agreed to loan up to an additional \$22,165 in funding for the Company, if and when agreed upon, but this additional amount was not ever loaned pursuant to the Note.

On July 12, 2020, the Convertible Promissory Note issued on January 14, 2020 matured. The Note was not repaid in full on or prior to the maturity date, so, pursuant to the terms of the conversion feature of the Convertible Promissory Note, the \$27,835 balance of the Convertible Note was converted into the Company's common stock shares on July 13, 2020. The conversion price was \$0.004 per share resulting in 6,958,758 shares being issued. The balance of the Note was \$-0- and \$27,835 at August 31, 2020 and February 29, 2020, respectively.

## 12% Subordinated Notes

Our 12% Subordinated Notes (“the Notes”) issued pursuant to a January 2010 private placement offering to accredited investors, resulted in \$595,000 in gross proceeds (of which \$250,000 was from a related party) to us and accrue interest at 12% per annum, payable semi-annually on January 29th and July 29th. On January 29, 2015, we and 12 of the 13 holders of the Notes agreed to extend the maturity date of the Notes for an additional two years to January 29, 2017. Effective January 29, 2017, the maturity date of the Notes and the expiration date of the warrants that were issued in conjunction with the Notes were extended for an additional two years to January 29, 2019. The 980,000 warrants held by ten noteholders expired on January 29, 2019.

We have informed the Note holders that the payment of principal and final interest will be late and is subject to future financing being completed. The Notes principal of \$565,000 was payable in full at the amended maturity date of the Notes, and has not been paid. Interest continues to accrue on the unpaid \$565,000 principal balance. The terms of the Notes, state that should the Board of Directors decide that the payment of the principal and any unpaid interest would impair the financial condition or operations of the Company, we may then elect a mandatory conversion of the unpaid principal and interest into our common stock at a conversion rate equal to 75% of the average closing price of our common stock over the 20 consecutive trading days preceding December 31, 2018. As of August 31, 2020, no conversion of the unpaid principal and interest into the Company’s common stock has occurred. The accrued interest on the 12% Notes at August 31, 2020 and February 29, 2020 was \$306,421 and \$272,428, respectively. There was no unamortized debt discount remaining at August 31, 2019 and February 28, 2019.

12% Note balances at August 31, 2020 and February 29, 2020 are set forth in the table below:

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
12% Subordinated Notes	\$ 315,000	\$ 315,000
12% Subordinated Notes – related party	250,000	250,000
Total 12% Subordinated Notes balance	<u>\$ 565,000</u>	<u>\$ 565,000</u>

12% Note balances – accrued interest at August 31, 2020 and February 29, 2020 are set forth in the table below:

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
Accrued interest 12% Subordinated Notes	\$ 78,914	\$ 59,962
Accrued interest 12% Subordinated Notes – related party	227,507	212,466
Total accrued interest 12% Subordinated Notes	<u>\$ 306,421</u>	<u>\$ 272,428</u>

The accrued interest owed on the 12% Subordinated Note to the related party is presented on our Balance Sheets under the caption *Accounts payable – related party* rather than under the caption *Accrued interest*.

## Production Revenue Payable

Since December 2018, the Company has been conducting a fundraising program to fund the drilling of future wells in California and Michigan and to settle some of its historical debt. The purchasers of production payment interests will receive a production revenue payment on future wells to be drilled in California and Michigan in exchange for their purchase. As of August 31, 2020, the production revenue payment program balance was \$950,100 of which \$550,100 was owed to a related party - the Company’s Chairman, President and Chief Executive Officer.

The production payment interest entitles the purchasers to receive production payments equal to twice their original amount paid, payable from a percentage of the Company’s future net production payments from wells drilled after the date of the purchase and until the Production Payment Target (as described below) is met. The Company shall pay fifty percent of its net production payments from the relevant wells to the purchasers until each purchaser has received two times the purchase price (the “Production Payment Target”). Once the Company pays the purchasers amounts equal to the Production Payment Target, it shall thereafter pay a pro-rated eight percent (8%) of \$1.3 million on its net production payments from the relevant wells to each of the purchasers. However, if the total raised is less than the target \$1.3 million, then the payment will be a proportionate amount of the eight percent (8%). Additionally, if the Production Payment Target is not met within the first three years, the Company shall pay seventy-five percent of its production payments from the relevant wells to the purchasers until the Production Payment Target is met.

The Company accounted for the amounts received from these sales in accordance with ASC 470-10-25 and 470-10-35 which require amounts recorded as debt to be amortized under the interest method as described in ASC 835-30, Interest Method. Consequently, the program balance of \$950,100 has been recognized as a production revenue payable. The Company determined an effective interest rate based on future expected cash flows to be paid to the holders of the production payment interests. This rate represents the discount rate that equates estimated cash flows with the initial proceeds received from the sales and is used to compute the amount of interest to be recognized each period. Estimating the future cash outflows under this agreement requires the Company to make certain estimates and assumptions about future revenues and payments and such estimates are subject to significant variability. Therefore, the estimates are likely to change which may result in future adjustments to the accretion of the interest expense and the amortized cost based carrying value of the related payables.

Accordingly, the Company has estimated the cash flows associated with the production revenue payments and determined a discount of \$1,188,117 as of August 31, 2020, which is being accounted as interest expense over the estimated period over which payments will be made based on expected future revenue streams. For the six months ended August 31, 2020 and 2019, amortization of the debt discount on these payables amounted to \$66,652 and \$215,129, respectively, which has been included in interest expense in the statements of operations.

Production revenue payable balances at August 31, 2020 and February 29, 2020 are set forth in the table below:

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
Estimated payments of production revenue payable	\$ 2,138,217	\$ 2,054,766
Less: unamortized discount	<u>(683,294)</u>	<u>(666,495)</u>
	1,454,923	1,388,271
Less: current portion	<u>(64,798)</u>	<u>(43,069)</u>
Net production revenue payable – long-term	<u>\$ 1,390,125</u>	<u>\$ 1,345,202</u>

#### *Paycheck Protection Program (PPP) Loan*

On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act commonly referred to as the CARES Act. One component of the CARES Act was the paycheck protection program (“PPP”) which provides small business with the resources needed to maintain their payroll and cover applicable overhead. The PPP is implemented by the Small Business Administration (“SBA”) with support from the Department of the Treasury. The PPP provides funds to pay up to eight weeks of payroll costs including benefits. Funds can also be used to pay interest on mortgages, rent, and utilities. The Company applied for, and was accepted to participate in this program. On May 11, 2020, the Company received funding for approximately \$74,355.

The loan is a two-year loan with a maturity date of May 5, 2022. The loan bears an annual interest rate of 1%. The loan shall be payable monthly with the first six monthly payments deferred. It is the Company’s intent to apply for loan forgiveness under the provisions of Section 1106 of the CARES Act. Loan forgiveness is subject to the sole approval of the SBA. The Company is eligible for loan forgiveness in an amount equal to payments made during the 8-week period beginning on the Loan date, with the exception that no more than 25.0% of the amount of loan forgiveness may be for expenses other than payroll expenses. The Company used all loan proceeds to partially subsidize direct payroll expenses.

#### *Line of Credit*

The Company has an existing \$890,000 line of credit for working capital purposes with UBS Bank USA (“UBS”), established pursuant to a Credit Line Agreement dated October 24, 2011 that is secured by the personal guarantee of its Chairman, President and Chief Executive Officer. On July 10, 2017 a \$700,000 portion of the outstanding line of credit balance was converted to a 24 month fixed term annual percentage interest rate of 3.244% with interest payable monthly. On July 10, 2019, the 24 month fixed term loan amount of \$700,000 was renewed at the same annual percentage interest rate of 3.244% for an additional 24 months. The remaining principal balance of the line of credit has a stated reference rate of 0.249% + 337.5 basis points with interest payable monthly. The reference rate is based on the 30 day LIBOR (“London Interbank Offered Rate”) and is subject to change from UBS.

During the six months ended August 31, 2020 and 2019, the Company received advances on the line of credit of \$- and \$49,000, respectively. During the six months ended August 31, 2020 and 2019, the Company made payments to the line of credit of \$30,000 and \$30,000, respectively. Interest converted to principal for the six months ended August 31, 2020 and 2019 was \$14,706 and \$15,684, respectively. At August 31, 2020 and February 29, 2020, the line of credit had an outstanding balance of \$857,107 and \$872,401, respectively.

## Note Payable

In December 2018, we were able to settle an outstanding balance owed to one of our third-party vendors. This settlement resulted in a \$120,000 note payable issued to the vendor. Additionally, we agreed to issue 2,000,000 shares of the Company's common stock to the vendor as a part of the settlement. Based on the closing price of the Company's common stock on the date of the settlement, the value of the common stock transaction was determined to be \$6,000. The common stock shares were issued during the twelve months ended February 29, 2020. The note has a maturity date of January 1, 2022 and bears an interest rate of 10% rate per annum. Monthly interest is accrued and payable on January 1<sup>st</sup> of each anniversary date through maturity of the note. At August 31, 2020, the note principal balance of \$120,000 and the accrued interest had not been paid and were outstanding. At August 31, 2020 and February 29, 2020, the accrued interest on the Note was \$20,000 and \$14,000, respectively.

## Encumbrances

On October 17, 2018, a working interest partner in California filed a UCC financing statement in regards to payable amounts owed to the partner by the Company. As of August 31, 2020, we had no encumbrances on our crude oil project in Michigan.

## Operating Leases

The Company leases approximately 988 rentable square feet of office space from an unaffiliated third party for our corporate office located in Spokane Valley, Washington. Additionally, we lease approximately 416 and 695 rentable square feet from unaffiliated third parties for our regional operations office in Friendswood, Texas and storage and auxiliary office space in Wallace, Idaho, respectively. The lease in Friendswood is a 24 month lease that expires in October 2020. The Spokane Valley and Wallace leases are currently on a month-to-month basis. The Company's lease agreements do not contain any residual value guarantees, restrictive covenants or variable lease payments. The Company has not entered into any financing leases.

The Company determines if an arrangement is a lease at inception. Operating leases are recorded in operating lease right of use assets, net, operating lease liability – current, and operating lease liability – long-term on its balance sheet.

Operating lease assets represent the Company's right to use an underlying asset for the lease term and lease liabilities represent its obligation to make lease payments arising from the lease. Operating lease assets and liabilities are recognized at the commencement date based on the present value of lease payments over the lease term. As the Company's leases do not provide an implicit rate, the Company uses its incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. The incremental borrowing rate used at adoption was 5.85%. Significant judgement is required when determining the Company's incremental borrowing rate. Lease expense for lease payments is recognized on a straight-line basis over the lease term.

The Balance Sheet classification of lease assets and liabilities is as follows:

	<u>August 31, 2020</u>	<u>February 29, 2020</u>
<b>Assets</b>		
Operating lease right-of use assets, beginning balance	\$ 5,857	\$ 13,787
Current period amortization	(4,393)	(7,930)
Total operating lease right-of-use asset	<u>1,464</u>	<u>5,857</u>
<b>Liabilities</b>		
Operating lease liability – current	1,464	5,857
Operating lease liability – long-term	—	—
Total lease liabilities	<u>\$ 1,464</u>	<u>\$ 5,857</u>

Future minimum lease payments as of August 31, 2020 under non-cancellable operating leases are as follows:

<u>Fiscal Year Ended</u>	<u>Annual Office Lease Obligation</u>
February 28, 2021	\$ 1,550
Total lease payments	1,550
Less: imputed interest	(86)
Operating lease liability	1,464
Less: operating lease liability – current	(1,464)
Operating lease liability, long-term	<u>\$ —</u>

Rent expense for the six months ended August 31, 2020 and 2019 was \$11,745, respectively.

### **Capital Commitments**

Daybreak 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 the right to participate in future drilling on certain leases or the loss of the lease itself. These ongoing capital commitments may also cause us to seek additional capital from sources outside of the Company. The current uncertainty in the credit and capital markets, and the current economic downturn in the energy sector, may restrict our ability to obtain needed capital.

#### *Management Plans to Continue as a Going Concern*

We continue to implement plans to enhance Daybreak's ability to continue as a going concern. The Company currently has a net revenue interest in 20 producing crude oil wells in our East Slopes Project located in Kern County, California. The revenue from these wells has created a steady and reliable source of revenue for the Company. Our average working interest in these wells is 36.6% and the average net revenue interest is 28.4%.

We anticipate revenues will continue to increase as the Company participates in the drilling of more wells in the East Slopes Project in California and as our drilling operations begin in Michigan. However given the current volatility and instability in hydrocarbon prices, the timing of any drilling activity in California and Michigan will be dependent on a sustained improvement in hydrocarbon prices and a successful refinancing or restructuring of our credit facility.

We believe that our liquidity will improve when there is a sustained improvement in hydrocarbon prices. Our sources of funds in the past have included the debt or equity markets and the sale of assets. While the Company does have positive cash flow from its crude oil properties, it has not yet established a positive cash flow on a company-wide basis. It will be necessary for the Company to obtain additional funding from the private or public debt or equity markets in the future. However, we cannot offer any assurance that we will be successful in executing the aforementioned plans to continue as a going concern.

Our financial statements as of August 31, 2020 do not include any adjustments that might result from the inability to implement or execute Daybreak's plans to improve our ability to continue as a going concern.

### **Critical Accounting Policies**

Refer to Daybreak's Annual Report on Form 10-K for the fiscal year ended February 29, 2020.

### **Off-Balance Sheet Arrangements**

As of August 31, 2020, we did not have any off-balance sheet arrangements or relationships with unconsolidated entities or financial partners that have been, or are reasonably likely to have, a material effect on our financial position or results of operations.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As a smaller reporting company, we are not required to provide the information otherwise required by this Item.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### ***Management's Evaluation of Disclosure Controls and Procedures***

As of the end of the reporting period, August 31, 2020, an evaluation was conducted by Daybreak management, including our President and Chief Executive Officer, who is also serving as our interim principal finance and accounting officer, as to the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(e) of the Exchange Act. Such disclosure controls and procedures are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods specified by the SEC rules and forms. Additionally, it is vital that such information is accumulated and communicated to our management, including our President and Chief Executive Officer, in a manner to allow timely decisions regarding required disclosures. Based on that evaluation, our management concluded that our disclosure controls were effective as of August 31, 2020.

#### ***Changes in Internal Control over Financial Reporting***

There have not been any changes in the Company's internal control over financial reporting during the three months ended August 31, 2020 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

#### ***Limitations***

Our management does not expect that our disclosure controls or internal controls over financial reporting will prevent all errors or all instances of fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and any design may not succeed in achieving its stated goals under all potential future conditions.

Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitation of a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**PART II  
OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

None

**ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this Form 10-Q Report, you should carefully consider the various factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended February 29, 2020, which could materially affect our business, financial condition or future results. Our Annual Report is available from the SEC at [www.sec.gov](http://www.sec.gov). The risks described in this report are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial could have a material adverse effect on our business, financial condition or future results of operations.

## ITEM 6. EXHIBITS

The following Exhibits are filed as part of the report:

<b>Exhibit Number</b>	<b>Description</b>
31.1 <sup>(1)</sup>	<a href="#">Certification of principal executive and principal financial officer as required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</a>
32.1 <sup>(1)</sup>	<a href="#">Certification of principal executive and principal financial officer as required pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</a>
101.INS <sup>(2)</sup>	XBRL Instance Document
101.SCH <sup>(2)</sup>	XBRL Taxonomy Schema
101.CAL <sup>(2)</sup>	XBRL Taxonomy Calculation Linkbase
101.DEF <sup>(2)</sup>	XBRL Taxonomy Definition Linkbase
101.LAB <sup>(2)</sup>	XBRL Taxonomy Label Linkbase
101.PRE <sup>(2)</sup>	XBRL Taxonomy Presentation Linkbase

(1) Filed herewith.

(2) Furnished herewith

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DAYBREAK OIL AND GAS, INC.

By: /s/ JAMES F. WESTMORELAND  
James F. Westmoreland, its  
President, Chief Executive Officer and interim  
principal finance and accounting officer  
(Principal Executive Officer, Principal Financial  
Officer and Principal Accounting Officer)

Date: October 14, 2020