



2014 ANNUAL FINANCIAL REPORT

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## ABBREVIATIONS

BA-CDOR	Banker's Acceptances – Canadian Dealer Offered Rate
bbbl	Barrel
bbbl/d	Barrels per day
boe	Barrels of oil equivalent (6 mcf is equivalent to 1 bbl)
boe/d	Barrels of oil equivalent per day
btu	British thermal units
gj	Gigajoule
gj/d	Gigajoules per day
m	Thousand
mcf	Thousand cubic feet
mcf/d	Thousand cubic feet per day
mm	Million
mmbtu	Million British thermal units
AECO	Alberta gas trading price
AESO	Alberta Electric Systems Operator
API	American Petroleum Institute
ASP	Alkaline Surfactant Polymer
LIBOR	London Interbank Offered Rate
NYMEX	New York Mercantile Exchange
WTI	West Texas Intermediate

## MANAGEMENT'S DISCUSSION AND ANALYSIS

Management's discussion and analysis ("MD&A") is a review of Zargon Oil & Gas Ltd.'s 2014 financial results and should be read in conjunction with the audited consolidated financial statements and related notes for the years ended December 31, 2014 and 2013. The 2014 and 2013 consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), which are also generally accepted accounting principles ("GAAP") for publicly accountable enterprises in Canada. All amounts are in Canadian dollars unless otherwise noted. All references to "Zargon" or the "Company" refer to Zargon Oil & Gas Ltd.

In the MD&A, natural gas is converted to a barrel of oil equivalent ("boe") using six thousand cubic feet of gas to one barrel of oil. In certain circumstances, natural gas liquid volumes have been converted to a thousand cubic feet equivalent ("mcf") on the basis of one barrel of natural gas liquids to six thousand cubic feet of gas. Boes and Mcfes may be misleading, particularly if used in isolation. A conversion ratio of one barrel to six thousand cubic feet of natural gas is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Given that the value ratio based on the current price of crude oil as compared to natural gas is significantly different from the energy equivalency of 6:1, utilizing a conversion ratio on a 6:1 basis may be misleading as an indication of value.

The following are descriptions of additional GAAP measures used in this MD&A:

- The MD&A contains the term "funds flow from operating activities" ("funds flow"), which should not be considered an alternative to, or more meaningful than, "cash flows from operating activities" as determined in accordance with IFRS as an indicator of the Company's financial performance. This term does not have any standardized meaning as prescribed by IFRS and, therefore, the Company's determination of funds flow from operating activities may not be comparable to that reported by other companies. The Company evaluates its performance based on net earnings and funds flow from operating activities. The Company considers funds flow from operating activities to be a key measure as it demonstrates the Company's ability to generate the cash necessary to pay dividends, repay debt and to fund future capital investment. It is also used by research analysts to value and compare oil and gas companies, and it is frequently included in published research when providing investment recommendations.

The following are descriptions of non-GAAP measures used in this MD&A:

- The Company uses the term "debt net of working capital" or "net debt". Debt net of working capital, as presented, does not have any standardized meaning prescribed by IFRS and may not be comparable with the calculation of similar measures for other entities. Debt net of working capital, as used by the Company, is calculated as bank debt plus the full future face value of the convertible debenture of \$57.50 million and any working capital deficit excluding unrealized derivative assets/liabilities.
- Operating netbacks per boe equal total petroleum and natural gas sales per boe adjusted for realized derivative gains and/or losses per boe, royalties per boe, operating expenses per boe and transportation expenses per boe. Operating netbacks are a useful measure to compare the Company's operations with those of its peers.
- Funds flow netbacks per boe are calculated as operating netbacks less general and administrative expenses per boe, transaction costs per boe, interest and financing charges per boe, interest on the convertible debenture per boe, asset retirement expenditures per boe, cash portion of exploration and evaluation, other expense per boe and current income taxes per boe. Funds flow netbacks are a useful measure to compare the Company's operations with those of its peers.

References to “production volumes” or “production” in this document refer to sales volumes.

*Forward-Looking Statements* – This document offers our assessment of Zargon’s future plans and operations as at March 10, 2015, and contains forward-looking statements including:

- our expectations for operating costs and transportation costs referred to under the heading “Detailed Financial Analysis”;
- our expectations for general and administrative expenses referred to under the heading “Detailed Financial Analysis”;
- our expectations for our total asset retirement obligations referred to under the heading “Detailed Financial Analysis”;
- our expectations for our plans with respect to our Little Bow ASP project and the results therefrom referred to under the headings “Detailed Financial Analysis”, “Liquidity and Capital Resources”, “Risk Factors” and “Outlook”;
- our dividend policy referred to under the heading “2014 Highlights” and “Liquidity and Capital Resources”;
- our expected sources of funds for dividends referred to under the headings “Liquidity and Capital Resources” and “Risk Factors”;
- our expected sources of funds for capital expenditures referred to under the headings “Liquidity and Capital Resources”, “Risk Factors” and “Outlook”;
- our expectations for our borrowing costs, standby fees and debt levels referred to under the heading “Liquidity and Capital Resources”;
- our expectations for our field capital and ASP capital referred to under the heading “Risk Factors” and “Outlook”; and
- our expectations for production volumes referred to under the headings “Risk Factors” and “Outlook”.

Such statements are generally identified by the use of words such as “anticipate”, “continue”, “estimate”, “expect”, “forecast”, “may”, “will”, “project”, “should”, “plan”, “intend”, “believe” and similar expressions (including the negatives thereof). By their nature, forward-looking statements are subject to numerous risks and uncertainties, some of which are beyond our control, including such as those relating to results of operations and financial condition, general economic conditions, industry conditions, changes in regulatory and taxation regimes, volatility of commodity prices, escalation of operating and capital costs, currency fluctuations, the availability of services, imprecision of reserve estimates, geological, technical, drilling and processing problems, environmental risks, weather, the lack of availability of qualified personnel or management, stock market volatility, the ability to access sufficient capital from internal and external sources and competition from other industry participants for, among other things, capital, services, acquisitions of reserves, undeveloped lands and skilled personnel. Risks are described in more detail in our Annual Information Form, which is available on our website and at [www.sedar.com](http://www.sedar.com). Forward-looking statements are provided to allow investors to have a greater understanding of our business.

You are cautioned that the assumptions, including among other things, future oil and natural gas prices; future capital expenditure levels (including ASP); future production levels; future exchange rates; the cost of developing and expanding our assets; our ability to obtain equipment in a timely manner to carry out development activities; our ability to market our oil and natural gas successfully to current and new customers; the impact of increasing competition, our ability to obtain financing on acceptable terms; and our ability to add production and reserves through our development and acquisition activities used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be imprecise and, as such, undue reliance should not be placed on forward-looking statements. Our actual results, performance, or achievements could differ materially from those expressed in, or implied by, these forward-looking statements. We can give no assurance that any of the events anticipated will transpire or occur, or if any of them do, what benefits we will derive from them. The forward-looking information contained in this document is expressly qualified by this cautionary statement. Our policy for updating forward-looking statements is that Zargon disclaims, except as required by law, any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

This MD&A has been prepared as of March 10, 2015.

## ABOUT ZARGON OIL & GAS LTD.

Zargon Oil & Gas Ltd. (“the Company” or “Zargon”) is a publicly traded dividend-paying corporation incorporated in Canada with its head office located in Calgary, Alberta. The Company is engaged in the exploration, development and production of oil and natural gas in Canada and the United States (“US”).

### 2014 HIGHLIGHTS

- For calendar 2014, funds flow from operating activities of \$50.67 million (\$1.68 per basic share) was 13 percent lower than the \$58.48 million (\$1.95 per basic share) recorded in the prior year.
- Oil and liquids production averaged 4,190 barrels of oil and liquids per day in 2014, a 14 percent decrease from the preceding year as production additions from the 2014 drilling and exploitation activities were more than offset by property dispositions and natural production declines. Natural gas production averaged 11.58 million cubic feet per day in 2014, a 26 percent decrease from 2013, primarily due to property dispositions. Total 2014 production averaged 6,120 barrels of oil equivalent per day, an 18 percent decrease from the prior year.
- Zargon declared cash dividends totalling \$0.72 per common share during 2014 for a total of \$21.70 million. These cash dividends were equivalent to a payout ratio of 44 percent of funds flow from operating activities. As previously reported, Zargon has set the dividend at \$0.03 per common share per month starting with the January 2015 dividend.
- Net capital expenditures for the year totalled \$26.27 million; consisting of \$59.84 million of exploitation, development and facility programs and \$0.13 million of administrative assets which was offset by \$33.70 million of net property dispositions. The \$59.84 million of exploitation, development and facility programs include \$21.79 million of Alkaline Surfactant Polymer (“ASP”) project costs. The ASP costs included \$10.23 million of construction and exploitation costs and \$11.56 million of chemical costs. During the year, Zargon drilled 18.0 net wells yielding 17.0 net oil wells and 1.0 net injection well.
- Zargon’s December 31, 2014 debt, net of working capital (excluding unrealized derivative assets/liabilities) and using the full future face value of the convertible debenture of \$57.50 million, of \$113.43 million, was approximately 2.24 times 2014 funds flow from operating activities, and was down two percent from the 2013 year end net debt of \$116.24 million. At December 31, 2014, Zargon had approximately \$85 million of unutilized credit facilities available.

#### Oil and Liquids

##### Production

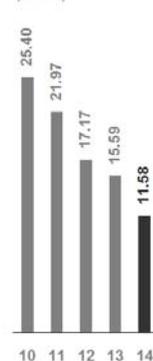
(bbl/d)



#### Natural Gas

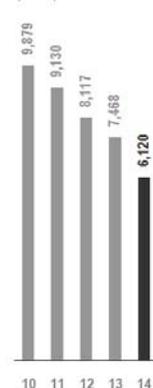
##### Production

(mmcf/d)



#### Production

(boe/d)



## Financial Highlights

(\$ millions, except for per share amounts)	2014	2013	2012
Petroleum and natural gas sales	<b>145.89</b>	158.65	157.95
Funds flow from operating activities	<b>50.67</b>	58.48	56.66
Per share – basic	<b>1.68</b>	1.95	1.91
Cash flows from operating activities	<b>50.40</b>	57.00	58.87
Per share – basic	<b>1.67</b>	1.90	1.99
Net earnings/(loss)	<b>5.95</b>	(5.90)	(5.38)
Per share – diluted	<b>0.19</b>	(0.20)	(0.18)
Total assets	<b>382.71</b>	452.98	445.11
Net capital expenditures <sup>(1)</sup>	<b>26.27</b>	41.74	30.25
Long term bank debt	<b>42.77</b>	39.97	35.74
Convertible debentures <sup>(2)</sup>	<b>57.50</b>	57.50	57.50
Cash dividends <sup>(3)</sup>	<b>21.70</b>	20.35	27.35

(1) Amounts include capital expenditures for corporate and property acquisitions acquired for cash consideration, equity issuances and net debt assumed.

(2) Amount is the full future face value of the convertible debentures.

(3) Cash dividends represent the cash portion only and do not include equity issued through the DRIP which was suspended September 2013.

## Production Highlights

	2014	2013	2012
Oil and liquids production (bbl/d)	<b>4,190</b>	4,870	5,255
Natural gas production (mmcf/d)	<b>11.58</b>	15.59	17.17
Production (boe/d)	<b>6,120</b>	7,468	8,117
Oil weighting (%)	<b>68</b>	65	65

## DETAILED FINANCIAL ANALYSIS

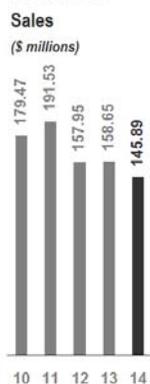
### Petroleum and Natural Gas Sales

(\$ millions)	2014	2013	Percent Change
Petroleum sales	<b>127.46</b>	141.97	(10)
Natural gas sales	<b>18.43</b>	16.68	10
Petroleum and natural gas sales	<b>145.89</b>	158.65	(8)

Petroleum and natural gas sales, exclusive of the impact of financial risk management contracts, were \$145.89 million in 2014 compared to \$158.65 million in 2013. Higher commodity prices in 2014 were offset by lower production. For 2014, the relative weighting of production revenue from oil and liquids decreased to 87 percent (89 percent in 2013) with 13 percent coming from the sale of natural gas (11 percent in 2013). Average production volumes in 2014 decreased to 6,120 barrels of oil equivalent per day compared to the prior year's 7,468 barrels of oil equivalent per day. Of the 6,120 barrels of oil equivalent per day of production volumes in 2014, oil and liquids were 68 percent (32 percent natural gas), as compared to 65 percent in 2013.

Natural gas production in 2014 decreased 26 percent, and oil and liquids production decreased 14 percent from 2013 levels. Oil and liquids production declines were due to the 2014 property dispositions and naturally occurring production declines that were partially offset by ongoing oil exploitation programs. Natural gas production declines continued as a result of property dispositions and a planned multi-year

### Petroleum and Natural Gas Sales



strategy to de-emphasize the natural gas business. The average field price of oil and liquids received by Zargon increased to \$83.35 per barrel in 2014, up four percent from \$79.88 per barrel in 2013. The average Zargon realized field price of natural gas was \$4.36 per thousand cubic feet in 2014, a 49 percent increase from \$2.93 per thousand cubic feet realized in 2013.

### Production by Core Area

	2014			2013		
	Oil and Liquids (bbl/d)	Natural Gas (mmcf/d)	Equivalents (boe/d)	Oil and Liquids (bbl/d)	Natural Gas (mmcf/d)	Equivalents (boe/d)
Alberta Plains North	1,158	8.63	2,596	1,288	12.48	3,368
Alberta Plains South	1,299	2.53	1,720	1,661	2.75	2,119
Williston Basin	1,733	0.42	1,804	1,921	0.36	1,981
	<b>4,190</b>	<b>11.58</b>	<b>6,120</b>	<b>4,870</b>	<b>15.59</b>	<b>7,468</b>

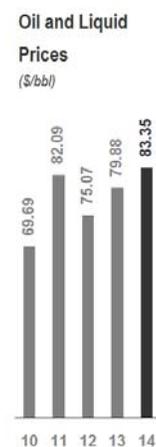
### Pricing

Average for the period	2014	2013	2012
<b>Natural Gas:</b>			
NYMEX average daily spot price (\$US/mmbtu)	4.37	3.72	2.75
AECO average daily spot price (\$Cdn/mmbtu)	4.50	3.17	2.39
Zargon realized field price before the impact of physical and financial risk management contracts (\$Cdn/mcf)	4.46	2.93	2.16
Zargon realized field price after the impact of physical and financial risk management contracts (\$Cdn/mcf)	4.04	2.94	2.18
Zargon realized natural gas field price differential before the impact of physical and financial risk management contracts	0.04	0.24	0.23
<b>Crude Oil:</b>			
WTI (\$US/bbl)	93.00	97.97	94.21
Edmonton par price (\$Cdn/bbl)	94.48	92.96	86.15
Zargon realized field price before the impact of financial risk management contracts (\$Cdn/bbl)	83.35	79.88	75.07
Zargon realized field price after the impact of financial risk management contracts (\$Cdn/bbl)	82.65	79.71	75.02
Zargon realized oil field price differential <sup>(1)</sup>	11.13	13.08	11.08

(1) Calculated as Zargon's realized field price before the impact of financial risk management contracts (\$Cdn/bbl) as compared to Edmonton par price (\$Cdn/bbl).

### Petroleum (Oil and Natural Gas Liquids) Pricing

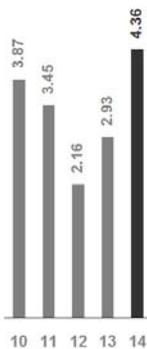
Zargon's field oil and natural gas liquids prices are adjusted at the point of sale for transportation charges and oil quality differentials from an Edmonton light sweet crude price that fluctuates with world commodity prices. In 2014, Zargon's average oil and liquids field price, exclusive of the impact of financial risk management contracts, increased four percent to \$83.35 per barrel from \$79.88 per barrel in 2013 and was 11 percent higher than the \$75.07 per barrel received in 2012. The field price differential for Zargon's average blended 27 degree API crude stream was \$11.13 per barrel less than the 2014 Edmonton reference crude price, which compares to the 2013 differential of \$13.08 per barrel and the 2012 differential of \$11.08 per barrel.



## Natural Gas

### Prices

(\$/mcf)



## Natural Gas Pricing

The average field natural gas price for 2014 increased to \$4.36 per thousand cubic feet, which is 49 percent higher than the 2013 average of \$2.93 per thousand cubic feet (before the impact of financial risk management contracts) and 102 percent higher than the 2012 average of \$2.16 per thousand cubic feet (before the impact of financial risk management contracts). Historically, Zargon's field prices have shown a small discount to the benchmark AECO average daily price due to transportation tariffs beyond the Zargon sales point. The 2014 field price differential for Zargon's natural gas was a discount of \$0.04 per thousand cubic feet, compared to discounts of \$0.24 and \$0.23 per thousand cubic feet (exclusive of the impact of physical and financial risk management contracts) in 2013 and 2012, respectively.

## Royalties

(\$ millions)	2014	2013	Percent Change
Royalties	27.40	29.33	(7)
Percentage of revenue	18.8%	18.5%	

Royalties include payments made to the Crown, freehold owners and third parties. Reported royalties also include the cost of the Saskatchewan Resource Surcharge ("SRC") and the cost of North Dakota state oil production/extraction taxes. During 2014, total royalties were \$27.40 million, a decrease of seven percent from \$29.33 million in 2013. The variations in royalty rates generally track changes in production volumes and prices. As a percentage of gross sales, royalties were 18.8 percent in 2014 compared to 18.5 percent in 2013 and 19.1 percent in 2012. On a commodity basis, natural gas royalties averaged 11.2 percent in 2014, a minimal decrease from the previous year's average of 11.3 percent. Oil royalties averaged 19.9 percent, up slightly from the prior year rate of 19.3 percent.

During 2014, 57 percent (2013 – 59 percent) of the total royalties were paid to provincial and state governments, with the remainder paid to freehold owners and other third parties. The SRC charges were \$0.87 million in 2014, a decrease from \$1.01 million in the prior year and \$1.00 million in 2012. North Dakota state oil production/extraction taxes were \$0.89 million in 2014 and compared to \$0.92 million in 2013.

## Risk Management Activities

Zargon's commodity price risk management policy, which is approved by the Board of Directors, allows for the sale of up to a certain percentage of its estimated before royalty production volumes for oil and natural gas up to a 30 month period. Zargon may also enter into interest rate swaps and physical electricity hedges.

For 2014, the total realized derivative loss was \$2.59 million; compared to a loss of \$0.46 million in 2013 and a loss of \$0.14 million in 2012. For 2014, there was a \$1.07 million loss (equivalent to a decrease of \$0.48 per barrel of oil equivalent) from oil financial risk management transactions, a \$1.34 million loss (equivalent to a decrease of \$0.60 per barrel of oil equivalent) from natural gas financial risk management transactions and a \$0.18 million loss (equivalent to a decrease of \$0.08 per barrel of oil equivalent) from interest rate swaps. Oil swaps are settled against the NYMEX WTI pricing index, natural gas swaps and basis hedges are settled against the AECO pricing index and interest rate swaps are settled against the Bankers' Acceptance-Canadian Dealer Offer Rate ("BA-CDOR").

Zargon's management considers financial risk management contracts to be effective on an economic basis, but does not designate these contracts as hedges for accounting purposes, and, accordingly, an unrealized gain or loss on these contracts is recorded based on the fair value (mark-to-market) of the contracts at year end. The 2014 net unrealized derivative gain totalled \$17.00 million, which compares to a \$9.72 million net unrealized derivative loss in 2013 (2012 – \$9.90 million gain). Specifically, the 2014 net unrealized derivative gain resulted from financial oil contract gains (\$16.43 million), financial gas contract gains (\$0.59 million) and financial interest rate swap losses (\$0.02 million). These non-cash unrealized derivative gains or losses are generated by the change over the reporting period in the mark-

to-market valuation of Zargon's risk management contracts. Realized and unrealized gains/losses on risk management contracts are included in "gain/loss on derivatives" in the consolidated statement of earnings/(loss) and their fair value is reflected in "derivative assets" or "derivative liabilities" on the consolidated balance sheet.

The electricity rate hedges are physical contracts and, therefore, do not have a mark-to-market and are included as part of operating costs. As a result of the contracts being physical contracts, there are no realized and unrealized gains or losses on the contracts.

As at December 31, 2014, the Company had the following outstanding commodity, basis, interest and electricity rate risk management contracts:

**Commodity Financial Risk Management Contracts:**

	Rate	Weighted Average Price	Range of Terms
Oil swaps	400 bbl/d	\$91.73 US/bbl	Jan. 1/15 – Mar. 31/15
	1,200 bbl/d	\$94.01 US/bbl	Jan. 1/15 – Jun. 30/15
Natural gas swaps	3,000 gj/d	\$4.18 Cdn/gj	Jan. 1/15 – Mar. 31/15

**Interest Rate Financial Risk Management Contracts:**

	Notional Value	Interest Rate <sup>(1)</sup>	Range of Terms
Interest rate swaps	\$20,000,000/month	1.640%	Jan. 1/15 – Jul. 26/16
	\$20,000,000/month	1.731%	Jan. 1/15 – Aug. 26/16

<sup>(1)</sup> Excludes the current stamping fee of 2.25 percent for each swap.

**Electricity Physical Risk Management Contracts:**

	Rate	Price	Range of Terms
Electricity forwards	1.5 MW/d	\$54.81/MWh	Jan. 1/15 – Dec. 31/15
	2.0 MW/d	\$52.55/MWh	Jan. 1/15 – Dec. 31/15

**Operating Expenses and Transportation Expenses**

(\$ millions)	2014	2013	Percent Change
Operating expenses	41.32	46.22	(11)
Transportation expenses	1.58	1.79	(12)
Total	42.90	48.01	(11)
Total (\$/boe)	19.21	17.61	9

Zargon's operating expenses decreased 11 percent to \$41.32 million in 2014 from \$46.22 million in 2013 due to fewer (post disposition) properties partially offset by the base expenditures required to operate the Little Bow ASP facility. Transportation expenses decreased 12 percent to \$1.58 million from \$1.79 million in 2013. On a per unit of production basis, operating and transportation expenses increased nine percent to \$19.21 per barrel of oil equivalent from \$17.61 in 2013 primarily due to the fixed Little Bow ASP facility costs. Looking forward, we expect total operating and transportation expenses to average approximately \$20 per barrel of oil equivalent until the significant low variable cost ASP production volumes materialize.

In particular, natural gas operating expenses in 2014 increased two percent to \$2.19 per thousand cubic feet from \$2.14 per thousand cubic feet in 2013. Oil operating and transportation expenses increased in 2014 to \$22.01 per barrel, an increase of nine percent from \$20.16 per barrel in 2013.

## Operating Netbacks

	2014		2013	
	Oil and Liquids (\$/bbl)	Natural Gas (\$/mcf)	Oil and Liquids (\$/bbl)	Natural Gas (\$/mcf)
Sales	83.35	4.36	79.88	2.93
Royalties	(16.56)	(0.49)	(15.44)	(0.33)
Realized gain/(loss) on derivatives	(0.70)	(0.32)	(0.17)	0.01
Operating expenses	(20.98)	(2.19)	(19.16)	(2.14)
Transportation expenses	(1.03)	–	(1.00)	–
Operating netbacks	44.08	1.36	44.11	0.47

The average oil and liquids price received, after realized derivative gains/losses, in 2014 of \$82.65 per barrel was four percent higher than the \$79.71 per barrel received in 2013. The average natural gas price received, after realized derivative gains/losses, in 2014 of \$4.04 per thousand cubic feet was 37 percent higher than the \$2.94 per thousand cubic feet received in 2013. Oil and liquids netbacks at \$44.08 per barrel were consistent with the 2013 netbacks of \$44.11 per barrel. Natural gas netbacks increased to \$1.36 per thousand cubic feet from \$0.47 per thousand cubic feet in 2013 due to an increase in natural gas prices. On a barrel of oil equivalent basis, overall 2014 operating netbacks increased to \$32.69 from \$29.67 in 2013.

## General and Administrative Expenses

(\$ millions, except as noted)	2014	2013	2012
Gross general and administrative expenses	15.62	14.77	16.76
Overhead recoveries	(2.99)	(3.27)	(3.21)
Net general and administrative expenses	12.63	11.50	13.55
Net expense after recoveries (\$/boe)	5.66	4.22	4.56
Number of office employees at year end	35	42	45

Gross general and administrative expenses (“G&A”) increased six percent in 2014 to \$15.62 million from \$14.77 million in 2013. On a per unit of production basis, net G&A expenses increased 34 percent to \$5.66 per barrel of oil equivalent compared to \$4.22 per barrel of oil equivalent in 2013 and \$4.56 in 2012. G&A expenses increased in 2014 primarily due to one-time employment related costs of \$1.55 million or \$0.70 per barrel of oil equivalent. In 2015, Zargon will target G&A expenses, exclusive of transaction costs, of less than \$5.00 per barrel of oil equivalent, although higher costs will be recorded in the first quarter due to further one-time employment related costs.

## Transaction Costs

Transaction costs include legal and consulting fees associated with business combinations such as property acquisitions/divestitures and corporate acquisitions, as well as fees associated with corporate reorganizations. IFRS 3 “Business Combinations” requires that transaction costs associated with business combinations be expensed in the consolidated statements of earnings and comprehensive income. For the year ended December 31, 2014, transaction costs were \$0.80 million, or \$0.36 per barrel of oil equivalent, and were comprised of legal and consulting fees associated with property acquisitions and divestitures during the year. For the year ended December 31, 2013, transaction costs were \$0.48 million or \$0.18 per barrel of oil equivalent and were comprised of legal and consulting fees associated with property acquisitions and divestitures during the year.

## Interest and Financing Charges on Long Term Bank Debt

A portion of Zargon’s borrowings are through its syndicated bank credit facilities. Interest and financing charges were \$2.56 million or \$1.15 per barrel of oil equivalent compared to \$2.34 million or \$0.86 per

barrel of oil equivalent in 2013 and \$3.06 million in 2012. The increase in interest and financing charges is a result of higher average borrowing levels partially offset by a lower effective interest rate. Zargon's effective interest and financing charge rate was 4.2 percent on an average outstanding bank debt of \$61.42 million in 2014, compared to 4.9 percent on an average bank debt of \$47.45 million in 2013, and 5.1 percent on an average bank debt of \$59.98 million in 2012. At year end 2014, Zargon's bank debt, net of working capital (excluding unrealized derivative assets/liabilities) and including the full \$57.50 million convertible debentures, totalled \$113.43 million, down two percent from \$116.24 million at December 31, 2013. To further protect Zargon's future cash flows, Zargon has two interest rate swaps. For more information on Zargon's credit facilities, see the "Long Term Bank Debt" section of this report.

### **Interest on Convertible Debentures**

Zargon has borrowings through its convertible debentures, which were issued in May 2012 and mature on June 30, 2017. Interest is payable semi-annually at a rate of six percent, calculated on the gross proceeds of \$57.50 million. The interest charges for 2014 were \$3.45 million or \$1.54 per barrel of oil equivalent. For more information on Zargon's convertible debentures, see the "Convertible Debentures" section of this report.

### **Current Taxes**

Current income taxes for 2014 were \$0.23 million compared to \$0.81 million in 2013. Zargon did not incur United States ("US") taxes in 2014, which compares to \$0.81 million incurred in 2013. The 2014 tax relates to withholding taxes on US dividends declared from Zargon's US subsidiary to its parent corporation. When compared to the prior period, current income taxes on US operations decreased primarily as a result of lower revenues and increased US field drilling expenditures in North Dakota.

Zargon is subject to normal course income tax audits by Canadian and US taxation authorities. During the fourth quarter of 2010, the Canada Revenue Agency ("CRA") commenced a flow-through share audit of a predecessor company from a prior corporate acquisition. During the first quarter of 2011, Zargon recorded a \$1.27 million provision which was comprised of a \$0.92 million charge to current income tax expense and a \$0.35 million charge to interest expense for the related Part XII.6 tax with respect to this ongoing flow-through share audit. The interest expense related to the Part XII.6 tax has been paid to the CRA and the remaining provision is \$0.39 million at December 31, 2014.

Tax pools as at December 31, 2014 were approximately \$282 million, down from the \$310 million of tax pools available to Zargon at the end of 2013. This nine percent decrease is due primarily from 2014 property dispositions. The Company is a taxable entity under the *Income Tax Act* (Canada); however, based on the current forward commodity strip, the Company is currently exempt from paying cash taxes in Canada.

For Canadian income tax purposes, all 2014 cash dividends paid or to be paid on Zargon's common shares are designated as "eligible dividends".

## Funds Flow

### Netbacks

(\$/boe)



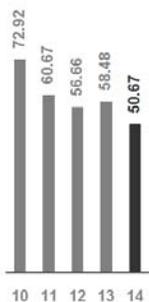
## Corporate Netbacks

(\$/boe)	2014	2013	2012
Petroleum and natural gas sales	65.31	58.20	53.16
Royalties	(12.26)	(10.76)	(10.14)
Realized derivative loss	(1.15)	(0.16)	(0.05)
Operating expenses	(18.50)	(16.96)	(15.92)
Transportation expenses	(0.71)	(0.65)	(0.52)
Operating netbacks	32.69	29.67	26.53
General and administrative expenses	(5.66)	(4.22)	(4.56)
Transaction costs	(0.36)	(0.18)	(0.01)
Interest and financing charges	(1.15)	(0.86)	(1.03)
Interest on convertible debentures	(1.54)	(1.27)	(0.78)
Asset retirement expenditures	(1.19)	(1.39)	(0.89)
Current income taxes	(0.10)	(0.30)	(0.19)
Funds flow netbacks	22.69	21.45	19.07

## Funds Flow

### from Operating Activities

(\$ millions)



Operating netbacks in 2014 increased 10 percent compared to 2013. On a barrel of oil equivalent basis, revenue of \$65.31 in 2014 was 12 percent higher than 2013, while operating netbacks increased to \$32.69 and funds flow netbacks increased six percent to \$22.69 per barrel of oil equivalent.

### Funds Flow from Operating Activities (see note at the beginning of the MD&A)

In 2014, decreased revenue as well as an increase in realized derivative contract losses and increased general and administrative expenses were partially offset by lower royalties, operating expenses and asset retirement expenditures which resulted in a 13 percent decrease in funds flow from operating activities to \$50.67 million, compared to \$58.48 million in 2013 and \$56.66 million in 2012. The corresponding funds flow per basic share was \$1.68 in 2014, a 14 percent decrease from \$1.95 in 2013 and an 12 percent decrease from \$1.91 in 2012. The basic per share statistics reflect a minimal increase in the weighted average outstanding shares to 30.14 million in 2014 from 30.02 million in 2013. The 2013 weighted average outstanding shares were also one percent higher than the 2012 amount of 29.61 million.

### Depletion and Depreciation

In 2014, Zargon's depletion and depreciation expense decreased one percent to \$44.82 million, compared to \$45.36 million in 2013. The lower charges are due to lower volumes, property dispositions and the year end reserve evaluation. Depletion and depreciation charges calculated on a unit of production method are based on total proved and probable reserves with a conversion of six thousand cubic feet of natural gas being equivalent to one barrel of oil. The 2014 depletion calculation includes \$103.61 million of future capital expenditures to develop the Company's reserves, but excludes \$6.61 million of unproven properties relating to E&E assets.

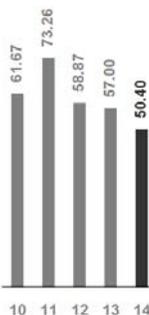
Property, plant and equipment are not depleted and depreciated for major development projects until production commences. For the year ended December 31, 2014, nil (2013 – \$42.45 million) of major development project property was not depleted or depreciated.

Zargon's depletion and depreciation, on a barrel of oil equivalent basis, increased 21 percent in 2014 to \$20.06 from \$16.64 in 2013 and increased 24 percent from the 2012 rate of \$16.22 due to the inclusion of the Little Bow ASP facility construction costs and reserves in the depletion calculation as the facility costs were not depleted during the construction phase.

## Cash Flows

### from Operating Activities

(\$ millions)



### **Accretion of Asset Retirement Obligations and Convertible Debentures**

For the year ended December 31, 2014, the non-cash accretion expense for asset retirement obligations was \$3.94 million compared to \$2.80 million in 2013 and \$2.77 million in 2012. The year-over-year increase is due to changes in the estimated future liability for asset retirement obligations. The significant assumptions used in this calculation are a risk-free rate of 3.25 percent, an inflation rate of two percent and payments to settle the retirement obligations occurring over the next 55 years, with the majority of the costs being incurred after 2029. At the end of the fourth quarter of 2014, the discount factor of 3.25 percent was decreased to 2.50 percent based on the Government of Canada long term bond rate. The estimated net present value of the total asset retirement obligation was \$86.56 million as at December 31, 2014, based on a total future liability of \$98 million.

The debt portion of Zargon's convertible debenture is also accreted over its term, up to the total maturity value of \$57.50 million. Accretion on the convertible debenture for 2014 is \$1.26 million compared to \$1.22 in 2013.

### **Share-Based Compensation**

Share-based compensation was \$1.50 million in 2014, \$0.22 million lower than the \$1.72 million expense in 2013 due to the lower value of new grants in the year and higher forfeiture rates. Zargon will continue to use fair value methodologies for future share award grants. These non-cash expenses will be recurring charges in future years if Zargon continues to grant employees and directors share awards.

Under the Common Share Rights Incentive Plans, directors, officers, employees and other service providers of the Company possess rights to acquire common shares at their option of either the original exercise price or a "modified price" as calculated per the provisions of the relevant plan. The Common Share Rights Incentive Plan (2007) (the "Old Plan") expired in the first quarter of 2013. Under the Common Share Rights Incentive Plan (2009) (the "New Plan"), if the monthly dividend exceeds the monthly return of 0.833 percent of the Company's recorded net book value of oil and natural gas properties (as defined in the New Plan), the entire amount (not the increment) of the dividend is deducted from the original grant price. Rights granted under either Plan generally vest over a three-year period and expire approximately five years from the grant date. Zargon uses a fair value methodology to value these common share rights grants. No further common share rights will be granted under these plans.

Under the Share Award Plan, directors, officers, employees and other service providers are granted the right to receive a defined number of shares in the future, which increases commensurately with each dividend declared by the Company after the grant date. The awards vest equally over four years and expire five years after grant date. Holders may choose to exercise upon vesting or at any time thereafter, with forfeiture of any shares not exercised by the expiry date. Zargon uses a fair value methodology to value these share awards. The Company is authorized to issue up to an aggregate of 2.50 million share awards; however, the number of shares reserved for issuance upon exercise of the options shall not, at any time, exceed 10 percent of the aggregate number of the total outstanding shares. Zargon uses a fair value methodology to value the common share awards. At December 31, 2014, Zargon had 0.68 million of share awards outstanding.

### **Unrealized Foreign Exchange**

An unrealized foreign exchange gain of nil in 2014 compared to a gain of \$0.15 million in 2013. Gains and losses result from transactions in US dollars when they are translated into Canadian dollars. The volatility in the US/Cdn dollar has created non-cash translation gains/losses as recorded in Zargon's consolidated statement of earnings/(loss) and comprehensive income/(loss).

### **Gain on Disposal of Assets**

As a result of the 2014 property dispositions, the Company had a gain of \$11.81 million (2013 - \$1.73 million loss) on disposals of capital assets in its consolidated statement of earnings/(loss) and comprehensive income/(loss).

## Exploration and Evaluation Expenses

Exploration and evaluation expenses for 2014 were \$1.27 million, and were \$2.74 million lower than the \$4.01 million incurred in 2013. Exploration and evaluation expenses were the result of land expiries and mostly related to expiries in west central and northern Alberta and North Dakota.

## Impairment Loss

As at December 31, 2014, the Company tested its cash generating units (“CGUs”) for impairment. Low crude oil and natural gas prices resulted in impairment of three CGUs (Alberta Plains South, Williston Basin Canada and Williston Basin US). The exploration and evaluation (“E&E”) assets associated with these CGUs were not included in this impairment test.

The recoverable amount of the CGUs was estimated based on their fair value less costs to sell. This estimate was determined using an after-tax discount rate of 11 percent and forecasted cash flows. The forecasted cash flows are prepared over the estimated life of the reserves in the CGUs. The prices used in this estimate are those used by independent reserve engineers.

Based on the assessment on December 31, 2014, the carrying amount of the three CGUs were determined to be \$20.76 million higher than their recoverable amount, and an impairment loss was recognized. In 2013, the Company determined there was \$4.39 million in impairment. No impairment losses from prior years were reversed in 2014.

## Impairment of Marketable Securities

As at December 31, 2014, the Company tested its marketable securities for impairment. Decreased values in market capitalizations resulted in impairment of one marketable security. The fair value of the marketable security was estimated at December 31, 2014 with its book value estimated at the time it was acquired.

Based on the assessment on December 31, 2014, the carrying amount of the marketable security was determined to be \$0.45 million higher than its recoverable amount, and an impairment loss was recognized. In 2013, the Company determined there was no impairment on marketable securities.

## Deferred Taxes

The provision for the deferred tax expense for 2014 was \$2.19 million compared to a deferred tax recovery of \$2.64 million in 2013 and a recovery of \$2.38 million in 2012. The 2014 deferred tax expense, when compared to the 2013 prior year recovery, is impacted by net earnings in 2014 compared to a net loss in 2013, which resulted from the increase in unrealized derivatives.

## Net Earnings

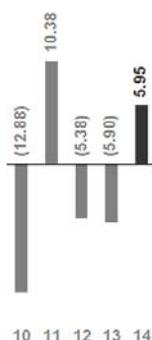
Zargon's 2014 net earnings were \$5.95 million, which compares to a net loss of \$5.90 million in 2013 and a \$5.38 million net loss in 2012. The net earnings/loss track the funds flow from operating activities for the respective periods modified by asset retirement expenditures and non-cash charges, which in 2014 were primarily related to depletion and depreciation, unrealized derivative gains, gains on disposal on properties, impairment losses and exploration and evaluation expense. On a per diluted share basis, the 2014 net earnings were \$0.19 compared to a net loss of \$0.20 in 2013 and a net loss of \$0.18 in 2012.

The 2014 net earnings were 12 percent of funds flow from operating activities, an increase over 2013 when the net loss represented a negative 10 percent of funds flow from operating activities. The net loss was a negative nine percent of funds flow from operating activities in 2012.

## Capital Expenditures

Total net capital expenditures (including net property dispositions) in 2014 of \$26.27 million decreased 37 percent from \$41.74 million in 2013, while Zargon's field capital expenditure program decreased 21 percent in 2014 to \$59.84 million from \$76.16 million in 2013. Field capital expenditures include ASP project expenditures of \$21.79 million in 2014 compared to \$35.33 million in 2013. In 2014, ASP project expenditures are broken down into \$10.23 million of project and exploitation costs and \$11.56 million of chemical costs compared to \$35.33 of project and exploitation costs in 2013. In 2014, Zargon drilled 22

Net Earnings/  
(Loss)  
(\$ millions)



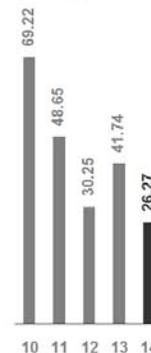
gross (18.0 net) wells compared to 19 gross (16.6 net) wells in 2013. Drilling and completion expenditures increased by 21 percent to \$21.05 million due to more wells drilled in 2014. The 2014 drilling program yielded 17.0 net oil wells for a success ratio of 100 percent. The remaining 1.0 net well was an injection well. Of the total 2014 field capital expenditures (excluding net property dispositions), \$7.40 million were expended on Alberta Plains North, \$31.29 million on Alberta Plains South (including ASP project expenditures) and \$21.15 million on Williston Basin properties. Additionally, \$0.13 million was incurred corporately on leasehold improvements and administrative assets. These expenditures were partially offset by \$33.70 million of net property dispositions.

Zargon began chemical injection at the ASP oil exploitation project facility at the Little Bow oil property in Alberta during the first half of 2014. The ASP project entails the injection of large volumes of dilutive chemical solution into a partially depleted oil reservoir to recover incremental oil reserves.

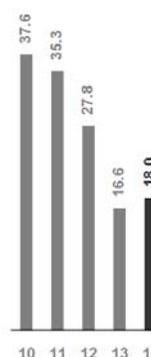
### Capital Expenditures

(\$ millions)	2014	2013	2012
Undeveloped land	2.46	4.36	5.45
Geological and geophysical (seismic)	0.76	1.27	2.63
Drilling and completion of wells	21.05	17.43	35.11
Well equipment and facilities	13.78	17.77	15.02
ASP project and exploitation costs	10.23	35.33	6.48
ASP chemical costs	11.56	—	—
Exploration and development	59.84	76.16	64.69
Property acquisitions	3.32	0.49	2.27
Property dispositions	(37.02)	(34.94)	(36.77)
Net property dispositions	(33.70)	(34.45)	(34.50)
Total net capital expenditures excluding administrative assets	26.14	41.71	30.19
Administrative assets	0.13	0.03	0.06
Total net capital expenditures	26.27	41.74	30.25

Net Capital Expenditures  
(\$ millions)



Drilling Activity  
(net wells)



### PROPERTY ACQUISITIONS/DISPOSITIONS

During 2014, Zargon completed property acquisitions and dispositions totalling net dispositions of \$33.70 million, which consisted of \$3.32 million of acquisitions and \$37.02 million of dispositions. Property dispositions were primarily related to the disposal of certain Alberta assets that permitted Zargon to focus on its core properties. Zargon also closed a minor acquisition to increase its working interest in the Little Bow area of Alberta.

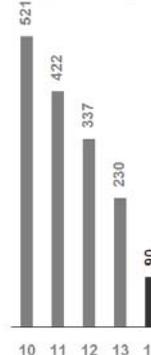
### LIQUIDITY AND CAPITAL RESOURCES

In 2014, the summation of the funds inflows coming from the funds flow from operating activities (\$50.67 million) and the increase in bank debt of \$2.80 million exceeded the summation of the funds outflows pertaining to the net capital expenditure program (\$26.27 million) and the cash dividends to shareholders (\$21.70 million) by \$5.50 million compared to \$0.62 million in 2013.

Zargon's financing philosophy and the three sources of funding are as follows:

- Internally generated funds flow from operating activities provides the basic level of funding for the Company's annual capital expenditures program and for dividends to shareholders;

Undeveloped Land  
(thousand net acres)



- Debt may be utilized for acquisitions or to expand capital programs when it is deemed appropriate. As at December 31, 2014, the Company had \$130 million in syndicated committed credit facilities of which approximately \$85 million or 65 percent was unutilized; and
- New equity, if available on favourable terms, can be utilized for acquisitions or to expand capital programs.

#### Cash Dividends Analysis

(\$ millions)	2014	2013	2012
Cash flows from operating activities	<b>50.40</b>	57.00	58.87
Net earnings/(loss)	<b>5.95</b>	(5.90)	(5.38)
Cash dividends relating to the period <sup>(1)</sup>	<b>(21.70)</b>	(20.35)	(27.35)
Excess of cash flows from operating activities over cash dividends	<b>28.70</b>	36.65	31.52
Excess (shortfall) of net earnings over cash dividends	<b>(15.75)</b>	(26.25)	(32.73)

(1) Cash dividends represent the cash portion only and do not include equity issued through the DRIP which was suspended September 2013.

Zargon maintained a monthly dividend of \$0.06 per common share throughout 2014 and 2013. Management monitors the Company's dividend policy with respect to forecasted net cash flows, debt levels and capital expenditures. Zargon's cash dividends are discretionary to the extent that these dividends are in compliance with Section 43 of the *Business Corporations Act* (Alberta) and do not cause a breach of the financial covenants under Zargon's credit facilities. As a petroleum and natural gas company, Zargon's reserve base is depleted with production and Zargon, therefore, relies on ongoing exploration, development, exploitation and acquisition activities to replace reserves and to offset production declines. The success of these capital programs, along with commodity price fluctuations and the Company's ability to manage costs, are the main factors influencing the sustainability of the Company's dividends.

In response to continuing weakness in both spot and forward commodity price markets and increased uncertainty in the capital markets, the Board of Directors of Zargon on December 22, 2014 revised Zargon's monthly dividend policy from \$0.06 per common share to \$0.03 per common share commencing in the first quarter of 2015.

These measures are intended to safeguard Zargon's financial and balance sheet strength. They provide additional flexibility required to continue to capitalize on Zargon's oil exploitation initiatives and to generate additional financing options for the implementation of the Little Bow ASP tertiary oil recovery project.

For the year ended December 31, 2014, cash flows from operating activities (after changes in non-cash working capital) of \$50.40 million exceeded cash dividends of \$21.70 million. In the year ended December 31, 2013, cash flows from operating activities (after changes in non-cash working capital) of \$57.00 million exceeded cash dividends of \$20.35 million.

For the year ended December 31, 2014, cash dividends of \$21.70 million exceeded net earnings of \$5.95 million. The net earnings included significant non-cash charges, particularly impairment losses, exploration and evaluation expenses and depletion and depreciation that do not impact cash flows. For the year ended December 31, 2013, cash dividends of \$20.35 million exceeded a net loss of \$5.90 million. Net earnings also include fluctuations in deferred taxes due to changes in tax rates and rules. In the instances where dividends exceed net earnings/(loss), a portion of the cash dividend paid may represent an economic return of the shareholders' capital.

For the year ended December 31, 2014, cash dividends and net capital expenditures totalled \$47.97 million, which was \$2.43 million lower than cash flows from operating activities (after changes in non-cash working capital) of \$50.40 million. For the year ended December 31, 2013, cash dividends and

net capital expenditures totalled \$62.09 million, which was \$5.09 million higher than cash flows from operating activities (after changes in non-cash working capital) of \$57.00 million. Zargon relies on access to debt and capital markets to the extent cash dividends and net capital expenditures exceed cash flows from operating activities (after changes in non-cash working capital). Over the long term, Zargon expects to fund future cash dividends and capital expenditures with its cash flows from operating activities; however, it may fund acquisitions and growth through additional debt and equity issuances. In the crude oil and natural gas industry, because of the nature of reserve reporting, the natural reservoir declines and the risks involved in capital investment, it is not possible to distinguish between capital spent on maintaining productive capacity and capital spent on growth opportunities, therefore, maintenance capital is not disclosed separately from development capital spending.

Prior to suspension, pursuant to the DRIP, Canadian shareholders were entitled to reinvest monthly cash dividends in additional shares of the Company. At the discretion of the Company, these additional shares were issued from Treasury at 95 percent of the “weighted average closing price”. For the purposes of the shares issued, the “weighted average closing price” was calculated as the weighted average trading price of shares for the five days prior to the dividend payment date. The DRIP was suspended starting with the September 2013 dividend paid on October 15, 2013.

### Capital Sources and Uses

(\$ millions)	2014	2013	2012
Funds flow from operating activities	50.67	58.48	56.66
Change in long term bank debt	2.80	4.23	(56.97)
Issuance of convertible debentures, net of transaction costs	–	–	54.65
Issuance of common shares	–	–	0.11
Cash dividends to shareholders <sup>(1)</sup>	(21.70)	(20.35)	(27.35)
Changes in working capital and other	(5.50)	(0.62)	3.15
<b>Total capital sources</b>	<b>26.27</b>	<b>41.74</b>	<b>30.25</b>

(1) For 2013 and 2012, cash distributions represent the cash portion only and do not include equity issued through the DRIP which was suspended September 2013.

### Funds Flow from Operating Activities

It is anticipated that Zargon’s 2015 exploration and development capital budget and cash dividends to shareholders will be financed through the Company’s funds flow from operating activities and its credit facilities. Funds flow is partially influenced by production volumes, commodity prices and the US/Canadian dollar exchange rates. Zargon’s 2015 estimated sensitivity to moderate fluctuations in these key business parameters (excluding derivative contracts) is shown in the accompanying table.

### Funds Flow Sensitivity Summary

	Change in 2015 Funds Flow	
	(\$ millions)	(\$/share)
Change of \$1.00 US/bbl in the price of WTI oil	1.12	0.04
Change in oil production of 100 bbl/d	1.16	0.04
Change of \$0.10 US/mcf in the price of NYMEX natural gas	0.16	0.01
Change in natural gas production of one mmcf/d	0.01	–
Change of \$0.01 in the \$US/\$Cdn exchange rate	0.80	0.03

### Long Term Bank Debt

On June 13, 2014, Zargon amended and renewed its syndicated credit facilities, the result of which was the reduction of the available facilities and borrowing base to \$150 million. The syndicated committed credit facilities were reduced to \$140 million after the Company’s semi-annual review was completed on

November 10, 2014 and were reduced to \$130 million on December 16, 2014 due to the disposition of assets. A \$300 million demand debenture on the assets of the Company has been provided as security for these facilities. The facilities are fully revolving for a 364 day period with the provision for an annual extension at the option of the lenders and upon notice from Zargon's Management. Should the facilities not be renewed, they convert to one year non-revolving term facilities at the end of the revolving 364 day period. Repayment would not be required until the end of the non-revolving term, and, as such, these facilities have been classified as long term debt. These facilities continue to be available for general corporate purposes and the potential acquisition of additional oil and natural gas properties.

For the 2015 renewal, it is anticipated that Zargon's borrowing costs will remain approximately the same as general debt pricing, and standby fees are expected to remain unchanged along with expected debt levels. Unhedged interest rates fluctuate under the syndicated facilities with Canadian prime, US prime and US base rates plus an applicable margin between 50 basis points and 200 basis points (2013 – 50 and 200 basis points, respectively), as well as with Canadian banker's acceptance and LIBOR rates plus an applicable margin between 200 basis points and 350 basis points (2013 – 200 and 350 basis points, respectively).

At December 31, 2014, \$42.77 million (December 31, 2013 - \$39.97 million) had been drawn on the syndicated committed credit facilities with any unused amounts subject to standby fees. Zargon reviews its compliance with its bank debt covenants on a quarterly basis and is in compliance as at December 31, 2014.

In the normal course of operations, Zargon enters into various letters of credit. At December 31, 2014, the approximate value of outstanding letters of credit totalled \$0.90 million (December 31, 2013 - \$0.87 million).

Zargon's debt, net of working capital (excluding unrealized derivative assets/liabilities) of \$113.43 million at December 31, 2014 was equivalent to 2.24 times 2014 funds flow from operating activities of \$50.67 million. At December 31, 2013, the debt net of working capital (excluding unrealized derivative assets/liabilities) was \$116.24 million, equivalent to 1.99 times 2013 funds flow from operating activities of \$58.48 million.

### Convertible Debentures

In addition to its long term bank debt, Zargon has borrowings through its convertible debentures, which were issued in May 2012 and mature on June 30, 2017. Interest is payable semi-annually at a rate of six percent, calculated on the gross proceeds of \$57.50 million.

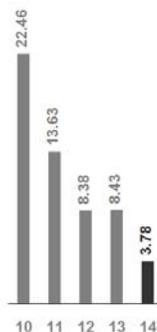
These debentures are convertible at the holder's option into Zargon's common shares at any time prior to the earlier of the maturity date and the date fixed for redemption at a conversion price of \$18.80 per share, subject to adjustment in certain circumstances. On or after June 30, 2015 but prior to maturity, the debentures will be redeemable at Zargon's option at par plus accrued and unpaid interest, provided that the weighted average trading price of the shares on the Toronto Stock Exchange during the 20 consecutive trading days ending on the fifth trading day preceding the date on which notice of redemption is given is not less than 125 percent of the conversion price. Zargon shall provide not more than 60 nor less than 30 days prior notice of redemption.

### Equity

At March 10, 2015, Zargon Oil & Gas Ltd. had 30.245 million common shares outstanding. Pursuant to the common share rights incentive plans and the share award plan, there are currently an additional 0.774 million common share incentive rights issued and outstanding.

During 2014, 17.57 million Zargon common shares traded on the Toronto Stock Exchange with a high trading price of \$9.90 per share, a low of \$3.01 per share and a closing price of \$3.78 per share. The 2014 trading statistics show a seven percent year-over-year increase in trading volume and a 55 percent decrease in the closing share price. Zargon's market capitalization at year end 2014 was approximately \$114 million, compared to approximately \$254 million at the end of 2013.

Zargon Year End  
Share Price  
(\$/share)



## Segmented Geographic Information

During 2014, approximately 91 percent (2013 – 92 percent) of Zargon's combined petroleum and natural gas revenue came from Western Canadian (Alberta and Saskatchewan) properties, with the remaining nine percent (2013 – eight percent) of revenue generated in the United States (North Dakota).

## OFF BALANCE SHEET ARRANGEMENTS

The Company has no guarantees or off balance sheet arrangements, except for letters of credit which have been issued in the normal course of business of approximately \$0.90 million as at December 31, 2014.

## RELATED PARTY TRANSACTIONS

During the year, the Company paid \$0.07 million (2013 – \$0.05 million) for legal services to a law firm in which a Board member is a partner. All amounts were based on normal commercial terms and conditions.

## ENVIRONMENTAL INITIATIVES IMPACTING ZARGON

There are no new material environmental initiatives impacting Zargon at this time.

## CONTRACTUAL OBLIGATIONS AND CONTINGENCIES

Zargon has certain contractual obligations relating to the lease of head office space, ASP related contracts and natural gas transportation sales contracts that extend for longer than one year as set out in the table below:

(\$ millions)	Total	2015	2016 to 2017	2018 to 2019	Thereafter
Head office lease and other	0.93	0.91	0.01	0.01	–
ASP related contracts	0.49	0.12	0.24	0.13	–
Natural gas transportation sales contracts	0.07	0.03	0.04	–	–
Total	1.49	1.06	0.29	0.14	–

## RISK FACTORS

There are numerous factors, both known and unknown, that can cause actual results or events to differ materially from forecast results. Although some of these risks are discussed in this section and in the Annual Information Form, these factors should not be construed as exhaustive.

Oil and natural gas operations involve many risks that even a combination of experience, knowledge and careful evaluation may not be able to overcome. The long term commercial success of Zargon depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. Without the continual addition of new reserves, any existing reserves Zargon may have at any particular time and production they will yield will decline over time as such existing reserves are depleted. A future increase of the Company's reserves will depend not only on its ability to develop and exploit any properties it may have from time to time, but also its ability to evaluate and acquire suitable producing properties or prospects. No assurance can be given that further commercial quantities of oil and natural gas will be discovered or acquired by Zargon.

Zargon's principal risks are finding and developing economic hydrocarbon reserves efficiently and being able to fund the capital program. The Company's need for capital will be both short term and long term in nature. Short term working capital will be required to finance accounts receivable and other similar short term assets, while the development of oil and natural gas properties (including the Little Bow ASP project) requires large amounts of long term capital.

Operational risks faced by Zargon include competition, environmental factors, reservoir performance uncertainties, access to qualified personnel, a complex regulatory and taxation environment and safety concerns.

The supply of service and production equipment at competitive prices is critical to Zargon's ability to add reserves at a competitive cost and produce the reserve in an economic and timely fashion. In periods of increased activity, these services and supplies can become difficult to obtain. Zargon attempts to mitigate this risk by developing strong long term relationships with suppliers and contractors.

Zargon attempts to manage its business risks. Zargon has an experienced, talented and highly motivated staff of oil and natural gas professionals. Zargon also operates almost all of its properties. This enables Zargon to control the timing, direction and costs related to the exploitation and development opportunities. Zargon's geological focus is on areas in which the prospects are well understood by management. Technological tools are regularly used to reduce risk and increase the probability of success.

We are subject to extensive regulation surrounding the health and safety of our people and the environment. We make every effort to comply with the regulations and, where less stringent than our standards, exceed applicable legal and other requirements. However, regulatory standards and community expectations are constantly evolving. As a result, we may be exposed to increased litigation, compliance costs and unforeseen environmental rehabilitation expenses despite our best efforts to work with governments and community groups to keep pace with regulations, laws and public expectations. Zargon complies with government regulations and has in place an up-to-date Emergency Response Plan. Environmental and safety policies and standards are adhered to and reviewed with all levels of management on a regular basis.

Zargon maintains an insurance program with policies encompassing property damage, business interruption, public and certain other liabilities and directors and officers' exposures. As part of our portfolio risk management policy, we regularly conduct an assessment of foreseeable loss potential, cash flow at risk, loss experience, claims received and insurance premiums paid and will make adjustments to the balance. The coverage provides a reasonable amount of protection from risk of loss; however, not all risks are foreseeable or insurable.

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of federal, provincial, state and local laws and regulations. Compliance with such legislation can require significant expenditures and a breach may result in imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating expenses. Given the evolving nature of the debate related to climate change and the control of greenhouse gases and resulting requirements, it is not possible to predict either the nature of those requirements or the impact on the Company and its operations and financial condition.

The financial risks of global credit conditions, equity availability from the capital markets, commodity prices, interest rates, royalty rates, government intervention and taxation levels in the oil and natural gas industry are largely beyond Zargon's control. The Company's approach to managing these risks is to maintain a prudent level of debt and to employ forecasting and budgeting projections. In addition, from time to time, Zargon may use financial instruments to reduce corporate risk in certain situations. For a listing of financial instruments, refer to Note 16 in the audited consolidated financial statements for the year ended December 31, 2014.

Zargon's operational results and financial condition, and, therefore, the amount of capital expenditures and future dividend payments made to shareholders, are dependent on the prices received for oil and natural gas production. Natural gas production in the US has continually increased and, as a consequence, North American natural gas inventories are at elevated levels. Natural gas prices increased in 2014 from 2013 but long term pricing is uncertain as prices decreased towards the end of

2014. Low natural gas prices will affect Zargon's cash flow, but do not make up a significant portion of the business. Record worldwide production of oil in 2014 has led to higher inventories and lower prices. Consequently, Zargon's field oil prices dropped significantly at the end of 2014 and will affect Zargon's revenues. Any movement in oil and natural gas prices will have an effect on Zargon's ability to continue with its capital expenditure program and its ability to pay dividends. Future declines in oil and natural gas prices may result in future declines in, or elimination of, any future dividends. Oil and natural gas prices are determined by economic and, in some circumstances, political factors. Supply and demand factors, including weather and general economic conditions as well as conditions in other oil and natural gas regions, impact prices. Zargon may manage the risk associated with changes in commodity prices by entering into oil or natural gas price risk management contracts. If Zargon engages in activities to manage its commodity price exposure, it may forego the benefits it would otherwise experience if commodity prices were to increase. In addition, commodity risk management contract activities could expose Zargon to losses. To the extent that Zargon engages in risk management activities related to commodity prices, it will be subject to credit risks associated with counterparties with which it contracts.

## SIGNIFICANT ACCOUNTING JUDGMENTS, ESTIMATES AND ASSUMPTIONS

Zargon has continuously refined and documented its management and internal reporting systems to ensure that accurate, timely, internal and external information is gathered and disseminated.

Zargon's financial and operating results incorporate certain estimates including:

- Estimated revenues, royalties and operating expenses on production as at a specific reporting date but for which actual revenues and costs have not yet been received;
- Estimated capital expenditures on projects that are in progress;
- Estimated depletion and depreciation charges that are based on estimates of oil and gas reserves that Zargon expects to recover in the future;
- Estimated fair values of risk management contracts that are subject to fluctuation depending upon the underlying commodity prices and foreign exchange rates;
- Estimated value of asset retirement obligations that are dependent upon estimates of future costs and timing of expenditures;
- Estimated future recoverable value of property, plant and equipment and goodwill and any associated impairment charges or recoveries;
- Estimated compensation expense under Zargon's share rights and share award plans; and
- Estimated deferred tax assets and liabilities based on current tax interpretations, regulations and legislation that is subject to change.

Zargon has hired individuals and consultants who have the skills required to make such estimates and ensures that individuals or departments with the most knowledge of the activity are responsible for the estimates. Further, past estimates are reviewed and compared to actual results, and actual results are compared to budgets in order to make more informed decisions on future estimates.

Zargon's leadership team's mandate includes ongoing development of procedures, standards and systems to allow Zargon staff to make the best decisions possible and ensuring those decisions are in compliance with Zargon's environmental, health and safety policies.

## CHANGES IN ACCOUNTING POLICIES

The Company's changes in accounting policies are discussed in Note 4 to the Financial Statements.

## FUTURE CHANGES IN ACCOUNTING POLICIES

The Company's future changes in accounting policies are discussed in Note 4 to the Financial Statements.

## DESIGN AND EVALUATION OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND DISCLOSURE CONTROLS AND PROCEDURES

Zargon is required to comply with National Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings" and is required to make specific disclosures with respect to NI 52-109. These disclosures can be summarized as follows:

- The President and Chief Executive Officer and Interim Chief Financial Officer has directed an evaluation of Disclosure Control and Procedures ("DC&P") and has concluded that DC&P are designed appropriately and are operating effectively as at December 31, 2014.
- The President and Chief Executive Officer and Interim Chief Financial Officer has directed an evaluation of Internal Controls over Financial Reporting ("ICFR") and has concluded that ICFR are designed appropriately and are operating effectively as at December 31, 2014.
- Zargon reports that no changes were made to ICFR during 2014 that have materially affected, or are reasonably likely to materially affect the Company's ICFR.
- Zargon has no interests in proportionately consolidated entities or variable interest entities other than oil and gas joint ventures. Accordingly, the scope of the design of DC&P and ICFR have not been limited to exclude controls, policies and procedures with respect to proportionately consolidated entities or variable interest entities.
- Zargon has not limited the scope of the design of DC&P and ICFR with respect to any businesses/assets acquired in 2014.

Because of their inherent limitations, DC&P and ICFR may not prevent or detect misstatements, errors or fraud. Control systems, no matter how well designed or operated, can provide only reasonable, not absolute assurance that the objectives of the control systems are met. Zargon uses the 1992 Committee of Sponsoring Organizations of the Treadway Commission ("COSO") Framework as the Company has not yet adopted the 2013 COSO Framework.

## OUTLOOK

Since mid-2014, oil prices have declined precipitously to unexpected levels and as a result, Zargon's current revenues and cash flows are significantly reduced. During these challenging times, Zargon will seek to improve cash flows by reducing all costs while restricting capital programs to only necessary expenditures. Subsequent to the now completed property disposition programs, Zargon's remaining portfolio of long-life low-decline oil exploitation properties is well suited to survive this period of low oil prices. With the Little Bow ASP tertiary project built, commissioned and demonstrating first responses, Zargon can anticipate stable and then increasing oil production volumes throughout the rest of the decade with only modest capital expenditures.

## SUMMARY OF QUARTERLY RESULTS

	2014			
	Q1	Q2	Q3	Q4
Petroleum and natural gas sales (\$ millions)	40.26	40.86	37.41	<b>27.35</b>
Net earnings/(loss) (\$ millions)	0.17	(2.02)	0.10	<b>7.70</b>
Net earnings/(loss) per diluted share (\$)	0.01	(0.07)	–	<b>0.19</b>
Funds flow from operating activities (\$ millions)	15.30	11.88	10.87	<b>12.63</b>
Funds flow from operating activities per diluted share (\$)	0.50	0.39	0.35	<b>0.41</b>
Cash flows from operating activities (\$ millions)	14.86	10.03	12.36	<b>13.15</b>
Cash flows from operating activities per diluted share (\$)	0.49	0.33	0.40	<b>0.43</b>
Cash dividends (\$ millions)	5.42	5.42	5.43	<b>5.43</b>
Cash dividends declared per common share (\$)	0.18	0.18	0.18	<b>0.18</b>
Net capital expenditures/(dispositions) (\$ millions)	15.48	13.37	6.09	<b>(8.67)</b>
Total assets (\$ millions)	462.66	461.70	426.51	<b>382.71</b>
Long term bank debt (\$ millions)	50.55	56.37	59.45	<b>42.77</b>
Convertible debentures (\$ millions) <sup>(1)</sup>	57.50	57.50	57.50	<b>57.50</b>
Net debt	121.72	128.88	129.11	<b>113.43</b>
Average daily oil and liquids production (bbl)	4,320	4,096	4,194	<b>4,150</b>
Average daily natural gas production (mmcf)	14.05	14.77	11.16	<b>6.43</b>
Average daily production (boe)	6,662	6,558	6,054	<b>5,222</b>
Average oil production weighting (%)	65	62	69	<b>79</b>
Average realized commodity field price before the impact of financial risk management contracts (\$/boe)	67.15	68.46	67.18	<b>56.93</b>
Funds flow netback (\$/boe)	25.52	19.90	19.51	<b>26.30</b>

(1) Amount is full future face value of the convertible debentures.

	2013			
	Q1	Q2	Q3	Q4
Petroleum and natural gas sales (\$ millions)	37.08	40.59	45.14	35.84
Net earnings/(loss) (\$ millions)	0.23	1.13	(2.35)	(4.91)
Net earnings/(loss) per diluted share (\$)	0.01	0.04	(0.08)	(0.16)
Funds flow from operating activities (\$ millions)	13.90	15.99	16.45	12.15
Funds flow from operating activities per diluted share (\$)	0.46	0.53	0.55	0.40
Cash flows from operating activities (\$ millions)	12.46	14.68	16.30	13.56
Cash flows from operating activities per diluted share (\$)	0.42	0.49	0.54	0.45
Cash dividends (\$ millions) <sup>(1)</sup>	4.75	5.01	5.17	5.42
Cash dividends declared per common share (\$)	0.18	0.18	0.18	0.18
Net capital expenditures (\$ millions)	16.19	2.42	17.54	5.59
Total assets (\$ millions)	450.34	437.88	441.87	452.98
Long term bank debt (\$ millions)	44.02	42.06	43.65	39.97
Convertible debentures (\$ millions) <sup>(2)</sup>	57.50	57.50	57.50	57.50
Net debt	120.10	111.33	117.61	116.24
Average daily oil and liquids production (bbl)	5,113	4,930	4,816	4,625
Average daily natural gas production (mmcf)	15.21	14.77	16.46	15.90
Average daily production (boe)	7,648	7,392	7,560	7,276
Average oil production weighting (%)	67	67	64	64
Average realized commodity field price before the impact of financial risk management contracts (\$/boe)	53.87	60.34	64.90	53.55
Funds flow netback (\$/boe)	20.20	23.77	23.64	18.14

(1) Cash dividends represent the cash portion only and do not include common shares issued through Zargon's Dividend Reinvestment Plan which was suspended September 2013.

(2) Amount is full future face value of the convertible debentures.

#### FOURTH QUARTER 2014

During the fourth quarter of 2014, Zargon's petroleum and natural gas sales of \$27.53 million were 26 percent lower than the previous quarter's sales. Production for the 2014 fourth quarter of 5,222 barrels of oil equivalent per day was 14 percent lower than the 2014 third quarter's production of 6,054 barrels of oil equivalent per day. Compared to the previous quarter, oil production was one percent lower at 4,150 barrels per day due to natural production declines. Fourth quarter natural gas production decreased 42 percent from the previous quarter to 6.43 million cubic feet per day due to the sale of natural gas properties in the second half of 2014. Average field prices received during the fourth quarter, before the impact of financial risk management contracts, were \$66.96 per barrel for oil and liquids, a 23 percent decrease compared to the 2014 third quarter and \$3.03 per thousand cubic feet for natural gas, a 22 percent decrease from the prior quarter. Zargon's field price differential for its crude oil stream decreased to an \$8.08 per barrel discount to the Edmonton reference crude oil price, a 34 percent improvement from Zargon's average differential of \$12.16 per barrel for the first nine months of 2014. Despite stabilized field price differentials from Edmonton Par price, Zargon's fourth quarter oil field price realizations were unfavourably reduced due to a decrease in WTI oil prices.

Funds flow from operating activities was \$12.63 million in the fourth quarter, an increase of 16 percent or \$1.76 million from the prior quarter. A comparative analysis of the primary factors that caused this quarter-over-quarter increase is as follows:

- Fourth quarter 2014 petroleum and natural gas sales of \$27.53 million were 26 percent lower than the 2014 third quarter sales of \$37.41 million. This sales decrease was a result of the 14 percent decrease in production and 23 percent decrease in oil and liquids pricing over the third quarter.
- Royalties for the fourth quarter were \$5.03 million, a decrease of \$2.42 million from the prior quarter as the average royalty rate for the quarter decreased to 18.4 percent from the 2014 third quarter rate of 19.9 percent.
- Realized derivative gains were \$5.51 million in the fourth quarter of 2014, a \$7.57 million increase from the prior quarter's \$2.06 million loss due to the weakening of oil prices. The fourth quarter derivative gains were comprised of gains on realized financial oil risk management contracts (\$5.49 million), gains on financial natural gas risk management contracts (\$0.06 million) and losses on financial interest rate swaps (\$0.04 million).
- Operating expenses were \$9.85 million for the quarter, unchanged from the third quarter of 2014. Transportation expenses were \$0.30 million, a 23 percent decrease over the prior quarter. On a per barrel of oil equivalent basis, operating expenses increased 16 percent to \$20.50 in the fourth quarter of 2014 compared to \$17.71 in the prior quarter and transportation expenses decreased 10 percent to \$0.63 from \$0.70 in the prior quarter. The quarterly increase in operating expenses was due to lower production and relatively stable costs in the fourth quarter.
- General and administrative expenses were \$2.43 million for the quarter, 42 percent lower than the third quarter of 2014 due to one-time employment related costs incurred in the third quarter. General and administrative expenses on a per barrel of oil equivalent basis were \$5.05 compared to \$7.56 in the prior quarter.
- Transaction costs incurred in the fourth quarter were \$0.25 million compared to \$0.36 million in the prior quarter. The transaction costs mainly related to the property disposition in the quarter.
- Interest and financing charges on long term bank debt were \$0.53 million, a decrease of 29 percent or \$0.22 million from the prior quarter. Due to cash from property dispositions used for debt repayments in the fourth quarter administrative fees in the third quarter, the average bank debt level decreased five percent to \$63.42 million compared to \$67.05 million in the third quarter of 2014, resulting in lower debt servicing charges. Interest on convertible debentures was \$0.86 million and was unchanged from the prior quarter.
- Asset retirement expenditures reflect the actual amounts incurred to abandon and reclaim wells. These asset retirement expenditures totalled \$0.85 million in the 2014 fourth quarter and increased 33 percent from the prior quarter amount of \$0.64 million.
- Current income taxes of \$0.14 million were \$0.19 million higher than in the 2014 third quarter. The increase was primarily due to withholding taxes on US dividends declared from Zargon's US subsidiary to its parent corporation in the fourth quarter of 2014.

Net earnings for the quarter were \$7.70 million, an increase of \$7.60 million compared to the prior quarter net earnings of \$0.10 million, mainly as a result of unrealized derivative gains and a gain of disposal of properties that was partially offset by an impairment loss. Net earnings track the funds flow from operating activities for the respective periods modified by asset retirement expenditures and non-cash charges, which included the following for the fourth quarter of 2014:

- Depletion and depreciation expense decreased by \$1.01 million to \$10.25 million in the 2014 fourth quarter. The decreased expense was due to a year end decrease in production volumes due to property sales.

- Fourth quarter 2014 unrealized derivative gains of \$10.75 million compared with third quarter unrealized derivative gain of \$11.22 million. These unrealized gains result from the mark-to-market of financial risk management contracts at each period end. These non-cash unrealized derivative gains are generated by the change over the reporting period in the mark-to-market valuation of Zargon's risk management contracts. In particular, lower year end futures resulted in unrealized risk management contract oil gains of \$10.36 million, unrealized risk management contract natural gas gains of \$0.38 million and interest rate swap gains of \$0.01 million.
- Accretion of convertible debentures remained unchanged at \$0.33 million compared to the prior quarter amount.
- The provision for accretion of asset retirement obligations for the 2014 fourth quarter was \$0.85 million, down eight percent from the prior quarter expense. The quarter-over-quarter decrease is due to changes in the estimated future liability for asset retirement obligations as a result of wells removed through property dispositions inclusive of wells acquired/disposed of in the quarter and changes resulting from revisions to the timing and the amounts of the original estimates of undiscounted cash flows.
- Share-based compensation expense increased by \$0.32 million during the fourth quarter of 2014 to \$0.49 million due to forfeitures in the third quarter.
- Unrealized foreign exchange losses of \$0.03 million in the 2014 fourth quarter compared to nil for the prior quarter.
- Exploration and evaluation expenses in the fourth quarter were \$0.35 million and were 119 percent higher than the third quarter's \$0.16 million. Exploration and evaluation expenses were the result of land expiries.
- During the fourth quarter of 2014, Zargon closed an Alberta property disposition for gross proceeds of \$22.42 million. Zargon reported a net gain of \$19.96 million on the disposal of the assets.
- At the end of the fourth quarter, due to low commodity prices and the write off of certain natural gas reserves, three of the Company's CGUs were found to be impaired. The impairment was calculated to be a loss of \$20.76 million. The E&E assets associated with these CGUs were not included in this impairment test. Additionally, an investment in marketable securities was found to be impaired and a \$0.45 million charge was taken on the investment.
- The deferred tax expense was \$2.97 million during the quarter compared to a deferred tax recovery of \$0.28 million from the third quarter of 2014. The increase was due to net earnings before taxes of \$10.81 million compared to the third quarter losses before taxes of \$0.23 million.

Net capital dispositions were \$8.67 million during the fourth quarter of 2014 due to property dispositions, and compared to a prior quarter spend amount of \$6.09 million. Fourth quarter conventional expenditures were \$9.34 million while ASP expenditures were \$4.40 million (consisting of \$0.87 million of project and exploitation costs and \$3.53 million of chemical costs). These expenditures were offset by net dispositions of \$22.38 million in the quarter. Zargon also had \$0.03 million of administrative asset reductions in the quarter. During the fourth quarter, Zargon drilled 4.8 net wells, which resulted in 3.8 net oil wells and 1.0 net injection well.

Fourth quarter cash dividends to shareholders of \$0.06 per common share per month totalled \$5.43 million and compared to the prior quarter's \$0.06 per common share per month dividend that totalled \$5.43 million.

## ADDITIONAL INFORMATION

Additional information regarding the Company and its business operations, including the Company's Annual Information Form, is available on the Company's SEDAR profile at [www.sedar.com](http://www.sedar.com).

## MANAGEMENT'S REPORT

The consolidated financial statements of Zargon Oil & Gas Ltd. were prepared by management in accordance with International Financial Reporting Standards. The financial and operating information presented in this annual report is consistent with that shown in the consolidated financial statements.

Management has designed and maintains a system of internal accounting controls that provide reasonable assurance that all transactions are accurately recorded, that the financial statements reliably report the Company's operations and that the Company's assets are safeguarded. Timely release of financial information sometimes necessitates the use of estimates when transactions affecting the current accounting period cannot be finalized until future periods. Such estimates are based on careful judgments made by management.

Ernst & Young LLP, an independent chartered accountant firm, was appointed by a resolution of the shareholders to audit the consolidated financial statements of the Company and provide an independent opinion. They have conducted an independent examination of the Company's accounting records in order to express their opinion on the consolidated financial statements.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board of Directors exercises this responsibility through its Audit and Reserves Committee. The Audit and Reserves Committee, which consists of non-management directors, has met with Ernst & Young LLP and management in order to determine that management has fulfilled its responsibilities in the preparation of the consolidated financial statements. The Audit and Reserves Committee has reported its findings to the Board of Directors, who have approved the consolidated financial statements.



**C.H. Hansen**

President and Chief Executive Officer and Interim Chief Financial Officer

Calgary, Canada  
March 10, 2015

# INDEPENDENT AUDITORS' REPORT

To the Shareholders of **Zargon Oil & Gas Ltd.**

We have audited the accompanying consolidated financial statements of Zargon Oil & Gas Ltd., which comprise the consolidated balance sheets as at December 31, 2014 and 2013, and the consolidated statements of earnings/(loss), comprehensive income/(loss), changes in equity and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

## **Management's responsibility for the consolidated financial statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

## **Auditor's responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

## **Opinion**

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Zargon Oil & Gas Ltd. as at December 31, 2014 and 2013, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.



Chartered Accountants

Calgary, Canada

March 10, 2015

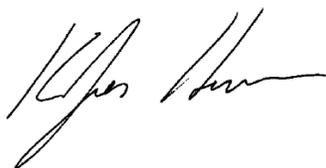
# CONSOLIDATED BALANCE SHEETS

(\$ thousands)	Notes	December 31, 2014	December 31, 2013
<b>ASSETS</b>			
Trade and other receivables		11,240	14,087
Deposits and prepaid expenses		1,226	997
Investment in marketable securities	15	1,542	800
Derivatives	15,16	12,004	22
<b>Total current assets</b>		<b>26,012</b>	<b>15,906</b>
Long term deposits		126	128
Property, plant and equipment, net	5,7	337,445	408,719
Intangible exploration and evaluation assets	6	6,610	13,331
Goodwill	6	4,770	2,969
Deferred tax assets	17	7,743	11,924
<b>Total assets</b>		<b>382,706</b>	<b>452,977</b>
<b>LIABILITIES</b>			
Trade and other payables		24,971	32,450
Cash dividends payable	8	1,811	1,805
Provisions	9	385	399
Derivatives	15,16	122	5,000
<b>Total current liabilities</b>		<b>27,289</b>	<b>39,654</b>
Long term bank debt	10	42,770	39,968
Convertible debentures	11	53,735	52,478
Derivatives	15,16	75	210
Provisions	9	86,557	135,177
Deferred tax liabilities	17	10,940	11,945
<b>Total liabilities</b>		<b>221,366</b>	<b>279,432</b>
Commitments and contingencies	9,10,11,14,16,25		
<b>EQUITY</b>			
Shareholders' capital	13	257,138	256,092
Accumulated other comprehensive income		2,538	493
Contributed surplus	14	12,879	12,423
Equity component of debentures	11	3,640	3,640
Deficit		(114,855)	(99,103)
<b>Total equity</b>		<b>161,340</b>	<b>173,545</b>
<b>Total equity and liabilities</b>		<b>382,706</b>	<b>452,977</b>

*See accompanying notes to the consolidated financial statements.*

Dated on March 10, 2015 on behalf of the Board:

K.J. Harrison, Director



K.D. Kitagawa, Director



## CONSOLIDATED STATEMENTS OF EARNINGS/(LOSS) AND COMPREHENSIVE INCOME/(LOSS)

For the years ended December 31  
(\$ thousands, except per share amounts)

	Notes	2014	2013
Petroleum and natural gas sales		145,888	158,648
Royalties		(27,396)	(29,325)
<b>PETROLEUM AND NATURAL GAS REVENUE, NET OF ROYALTIES</b>		<b>118,492</b>	<b>129,323</b>
Gain/(loss) on unrealized derivatives	15,16	16,995	(9,724)
Loss on realized derivatives	15,16	(2,589)	(463)
<b>GAIN/(LOSS) ON DERIVATIVES</b>		<b>14,406</b>	<b>(10,187)</b>
<b>TOTAL INCOME</b>		<b>132,898</b>	<b>119,136</b>
Operating		41,318	46,224
Transportation		1,581	1,783
General and administrative		12,633	11,502
Transaction costs		802	484
Exploration and evaluation	6	1,267	4,013
(Gain)/loss on disposal of properties	5	(11,811)	1,733
Share-based compensation	14, 18	1,502	1,722
Unrealized foreign exchange gain		-	(149)
Impairment loss on property, plant and equipment	5,7	20,764	4,393
Impairment loss on marketable securities		450	-
Depletion and depreciation	5	44,816	45,357
<b>EXPENSES</b>		<b>113,322</b>	<b>117,062</b>
<b>EARNINGS BEFORE FINANCE EXPENSES AND INCOME TAXES</b>		<b>19,576</b>	<b>2,074</b>
Interest and financing charges	10	2,560	2,336
Interest on convertible debentures	11	3,450	3,450
Accretion of convertible debentures	11	1,257	1,217
Accretion of asset retirement obligations	9	3,937	2,802
<b>FINANCE EXPENSES</b>		<b>11,204</b>	<b>9,805</b>
<b>EARNINGS/(LOSS) BEFORE INCOME TAXES</b>		<b>8,372</b>	<b>(7,731)</b>
Current tax expense	17	231	812
Deferred tax expense/(recovery)	17	2,191	(2,643)
<b>INCOME TAXES</b>		<b>2,422</b>	<b>(1,831)</b>
<b>NET EARNINGS/(LOSS) FOR THE YEAR</b>		<b>5,950</b>	<b>(5,900)</b>
Currency translation adjustment that may be reclassified subsequent to net earnings		2,045	1,491
<b>OTHER COMPREHENSIVE INCOME FOR THE YEAR</b>		<b>2,045</b>	<b>1,491</b>
<b>TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR</b>		<b>7,995</b>	<b>(4,409)</b>
<b>NET EARNINGS/(LOSS) PER SHARE</b>			
Basic	19	0.20	(0.20)
Diluted	19	0.19	(0.20)

See accompanying notes to the consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(\$ thousands)	Notes	Shareholders' Capital	Accumulated Other Comprehensive Income	Contributed Surplus	Equity Component of Convertible Debentures	Deficit	Total Equity
<b>Balance at December 31, 2013</b>		<b>256,092</b>	<b>493</b>	<b>12,423</b>	<b>3,640</b>	<b>(99,103)</b>	<b>173,545</b>
Net earnings for the year		-	-	-	-	<b>5,950</b>	<b>5,950</b>
Dividends declared	8	-	-	-	-	<b>(21,702)</b>	<b>(21,702)</b>
Share-based compensation	14	-	-	<b>1,502</b>	-	-	<b>1,502</b>
Exercise of share awards	13	<b>1,046</b>	-	<b>(1,046)</b>	-	-	-
Translation differences on foreign subsidiary		-	<b>2,045</b>	-	-	-	<b>2,045</b>
<b>Balance at December 31, 2014</b>		<b>257,138</b>	<b>2,538</b>	<b>12,879</b>	<b>3,640</b>	<b>(114,855)</b>	<b>161,340</b>
<b>Balance at December 31, 2012</b>		254,400	(998)	11,133	3,640	(71,592)	196,583
Net loss for the year		-	-	-	-	(5,900)	(5,900)
Dividends declared	8	-	-	-	-	(21,611)	(21,611)
Issue of common shares pursuant to the DRIP	8,13	1,260	-	-	-	-	1,260
Share-based compensation	14	-	-	1,722	-	-	1,722
Exercise of share awards	13	432	-	(432)	-	-	-
Translation differences on foreign subsidiary		-	1,491	-	-	-	1,491
<b>Balance at December 31, 2013</b>		<b>256,092</b>	<b>493</b>	<b>12,423</b>	<b>3,640</b>	<b>(99,103)</b>	<b>173,545</b>

*See accompanying notes to the consolidated financial statements.*

# CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31 (\$ thousands)	Notes	2014	2013
<b>OPERATING ACTIVITIES</b>			
Net earnings/(loss) for the year		5,950	(5,900)
Adjustments for non-cash items:			
(Gain)/loss on sale of properties	5	(11,811)	1,733
(Gain)/loss on unrealized derivatives	15,16	(16,995)	9,724
Depletion and depreciation	5	44,816	45,357
Accretion of asset retirement obligations	9	3,937	2,802
Accretion of convertible debentures	11	1,257	1,217
Share-based compensation	14	1,502	1,722
Unrealized foreign exchange gain		–	(149)
Impairment loss on property, plant and equipment	7	20,764	4,393
Impairment loss on marketable securities		450	–
Deferred tax expense/(recovery)	17	2,191	(2,643)
Exploration and evaluation	6	1,267	4,013
Asset retirement expenditures	9	(2,654)	(3,788)
Funds flow from operating activities		50,674	58,481
Changes in operating working capital	20	(277)	(1,482)
Net cash flows from operating activities		50,397	56,999
<b>INVESTING ACTIVITIES</b>			
Additions to property, plant and equipment	5	(59,770)	(76,333)
Additions to intangible exploration and evaluation assets	6	(415)	(349)
Proceeds from disposal of property, plant and equipment	5	31,099	31,907
Proceeds from disposal of exploration and evaluation assets	6	5,922	3,033
Acquisition of property, plant and equipment		(3,111)	–
Change in long term deposits		2	141
Changes in investing working capital	20	(5,229)	572
Net cash flows used in investing activities		(31,502)	(41,029)
<b>FINANCING ACTIVITIES</b>			
Advances of bank debt	10	2,802	4,232
Cash dividends paid to shareholders	8	(21,702)	(20,351)
Changes in financing working capital	20	5	149
Net cash flows used in financing activities		(18,895)	(15,970)
<b>NET CHANGE IN CASH DURING THE YEAR AND CASH, END OF YEAR</b>		–	–

See supplemental cash flow information contained in Note 21.

See accompanying notes to the consolidated financial statements.

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014 with comparative figures for 2013.

All amounts are stated in Canadian Dollars unless otherwise noted.

## 1. REPORTING ENTITY

Zargon Oil & Gas Ltd. ("the Company" or "Zargon") is a publicly traded corporation, incorporated in Canada, with its head office located at Suite 700, 333-5<sup>th</sup> Avenue SW, Calgary, Alberta. The consolidated financial statements of the Company as at and for the years ended December 31, 2014 and its 2013 comparative periods are comprised of the Company and its wholly owned subsidiaries. The Company is engaged in the exploration, development and production of oil and natural gas in Canada and the United States ("US") and conducts many of its activities jointly with others; these financial statements reflect only the Company's proportionate interest in such activities.

## 2. BASIS OF PRESENTATION

### (a) Statement of compliance:

These consolidated financial statements represent the annual financial statements of the Company and its subsidiaries prepared in accordance with International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board ("IASB"). These consolidated financial statements were approved and authorized for issue by the Board of Directors on March 10, 2015.

### (b) Basis of measurement:

The consolidated financial statements have been prepared on a going concern basis under the historical cost basis except for derivative financial instruments measured at fair value. The methods used to measure fair values of derivative financial instruments are discussed in Note 3(iv), Note 4(i)(ii) and Note 15.

### (c) Functional and presentation currency:

Items included in the financial statements of each consolidated entity are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). Zargon's US subsidiaries' functional currency is US dollars, while the Canadian subsidiaries have a functional currency of Canadian dollars. The consolidated financial statements are presented in Canadian dollars, which is the Company's functional and presentation currency.

## 3. SIGNIFICANT ACCOUNTING JUDGMENTS, ESTIMATES AND ASSUMPTIONS

The preparation of the Company's consolidated financial statements requires management to make judgments, estimates and assumptions that affect the reported amounts of revenues, expenses, assets and liabilities, and the disclosure of contingent liabilities at the end of the reporting period. However, uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of the asset or liability affected in future periods.

Where applicable, further information about the significant accounting judgments, estimates and assumptions made in preparing the consolidated financial statements is disclosed in the notes specific to that item.

### (i) Property, plant and equipment and intangible exploration and evaluation assets:

Property, plant and equipment and intangible exploration and evaluation assets represent costs incurred in developing oil and natural gas reserves and maintaining or enhancing production from such reserves. The fair value of property, plant and equipment recognized in a business combination is based on market values. The market value of property, plant and equipment is the estimated amount for which property, plant and equipment could be exchanged on the acquisition date between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

The recoverability of development and production asset carrying values are assessed at the cash-generating unit (“CGU”) level. Determination of what constitutes a CGU is subject to management judgments. The asset composition of a CGU can directly impact the recoverability of the assets included therein. In assessing the recoverability of oil and gas properties, each CGU’s carrying value is compared to its recoverable amount.

The amount recorded for depletion and depreciation of property, plant and equipment and the assessment of these assets for impairment including intangible exploration and evaluation assets are based on estimates of proved and probable reserves, production rebates, oil and natural gas prices, future costs and other relevant assumptions. Exploration and evaluation assets are not depleted. All of Zargon’s petroleum and natural gas reserves are evaluated and reported by independent engineering consultants in accordance with Canadian Securities Administrators’ National Instrument 51-101 (“NI 51-101”). The estimation of reserves is a subjective process. Forecasts are based on engineering data, projected future rates of production, commodity prices and the timing of future expenditures, all of which are subject to numerous uncertainties and various interpretations. The Company expects that its estimates of reserves will change to reflect updated information. Reserve estimates can be revised upward or downward based on the results of future drilling, testing, production levels and changes in costs and commodity prices. By their nature, these estimates are subject to measurement uncertainty and the impact on the consolidated financial statements of changes in such estimates in future periods could be material.

(ii) Asset retirement obligation:

Inherent in the calculation of asset retirement obligations are numerous assumptions and judgements including the ultimate settlement amounts, inflation factors, risk-free discount rates, timing of settlement and changes in the legal and regulatory environments. To the extent future revisions to these assumptions impact the measurement of the existing asset retirement obligation liability, a corresponding adjustment is made to the property, plant and equipment balance. The risk-free discount rate is based on the approximate government of Canada long term bond rate.

(iii) Share-based compensation:

The Company measures the cost of equity-settled transactions with employees and directors by reference to the fair value of the equity instruments at the date at which they are granted. The fair value of share awards is measured by reference to the quoted market price of the shares on the date of grant. The fair value of stock options is measured using a Black Scholes option pricing model. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility (based on weighted average historic volatility adjusted for changes expected due to publicly available information), weighted average expected life of the instruments (based on historical experience and general option holder behaviour), expected dividends and the risk-free interest rate (based on Government of Canada bonds).

(iv) Fair value of financial instruments:

Where the fair value of certain financial assets and financial liabilities recorded in the consolidated balance sheet cannot be derived from active markets, their fair value is determined using valuation techniques including the discounted cash flow model. The inputs to these models are taken from observable markets where possible, but where this is not feasible, a degree of judgment is required in establishing fair values. The judgments include considerations of inputs such as liquidity risk, credit risk and volatility. Changes in assumptions about these factors could affect the reported fair value of financial instruments.

Trade and other receivables are designated as “loans and receivables”. Trade and other payables, cash dividends payable and long term bank debt are designated as “other liabilities”. The fair value of long term bank debt approximates its carrying amount because it is subject to variable rates of interest. The fair values of trade and other receivables, trade and other payables and cash dividends payable approximate their carrying amounts due to their short terms to maturity.

The Company’s convertible debentures are classified as debt with a portion of the proceeds allocated to equity representing the conversion feature. As the debentures are converted, a portion of debt and conversion feature components are transferred to share capital. The debt component associated with the convertible debentures are designated as “financial liability measured at amortized cost”. In addition, the fair value of the convertible debenture is disclosed in Note 15, which was determined using Level I inputs.

Derivative assets and liabilities are derivative financial instruments classified as “held-for-trading” and are carried at fair value.

All of the Company's risk management contracts are transacted in active markets. The Company classifies the fair value of these transactions according to the following hierarchy based on the amount of observable inputs used to value the instrument.

Investments in marketable securities are classified as "available-for-sale" and are carried at fair value. These investments are available on the active market and the Company classifies the fair value of these investments according to the following hierarchy based on the amount of observable inputs used to value the instruments.

- Level I

Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and value to provide pricing information on an ongoing basis.

- Level II

Pricing inputs are other than quoted prices in active markets included in Level I. Prices in Level II are either directly or indirectly observable as of the reporting date. Level II valuations are based on inputs, including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the market place.

- Level III

Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

#### 4. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements.

(a) Basis of consolidation:

(i) Subsidiaries:

Subsidiaries are entities controlled by the Company. Control exists when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

The purchase method of accounting is used to account for acquisitions of subsidiaries and assets that meet the definition of a business under IFRS. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the identifiable assets, liabilities and contingent liabilities acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the identifiable net assets of the subsidiary acquired, the difference is recognized immediately in the consolidated statement of earnings/(loss) and comprehensive income/(loss) as an impairment.

(ii) Jointly controlled operations and jointly controlled assets:

A joint venture is a contractual arrangement whereby two or more parties (venturers) undertake an economic activity that is subject to joint control. Joint control exists only when the strategic financial and operating decisions relating to the activity require the majority consent of the venturers. Many of the Company's oil and natural gas activities involve jointly controlled assets. The consolidated financial statements include the Company's share of these jointly controlled assets and its proportionate share of the relevant revenue and related costs.

(iii) Transactions eliminated on consolidation:

Intercompany balances and transactions, and any unrealized income and expenses arising from intercompany transactions, are eliminated in preparing the consolidated financial statements.

(b) Foreign currency:

(i) Transactions and balances:

Transactions in foreign currencies are translated to Canadian dollars at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated to Canadian dollars at the period end exchange rate. Foreign currency differences arising on translation are recognized in earnings.

(ii) Group companies:

The assets and liabilities of foreign operations are translated at the rate of exchange prevailing at the reporting date and their statements of earnings are translated at exchange rates prevailing at the dates of the transactions. The exchange differences arising on the translation are recognized in equity. On disposal of a foreign operation, the component of other comprehensive income relating to that particular foreign operation is recognized in the consolidated statement of earnings/(loss) and comprehensive income/(loss).

(c) Property, plant and equipment and intangible exploration and evaluation assets:

(i) Recognition and measurement:

*Exploration and evaluation costs:*

The Company accounts for exploration and evaluation (“E&E”) costs in accordance with IFRS 6 “Exploration for and Evaluation of Mineral Resources”. Undeveloped land is accounted for as exploration and evaluation assets on the consolidated balance sheet. Pre-license E&E costs and lease expiries are recognized in the consolidated statement of earnings/(loss) and comprehensive income/(loss) as incurred. Costs of exploring for and evaluating oil and natural gas properties are capitalized and the resulting intangible E&E assets are tested for impairment.

E&E costs related to each license/prospect are initially capitalized within “intangible exploration and evaluation assets”. Such E&E assets may include costs of license acquisition, technical services and studies, seismic acquisition, exploration drilling and testing, directly attributable overhead and administrative expenses, including remuneration of production personnel and supervisory management and the projected costs of retiring the assets (if any), but do not include general prospecting or evaluation costs incurred prior to having obtained the legal rights to explore an area, which are expensed directly to earnings as they are incurred.

E&E assets are not depleted and are carried forward until technical feasibility and commercial viability of extracting an oil or natural gas resource is considered to be determined. The technical feasibility and commercial viability of extracting a mineral resource is considered to be determined when proved and/or probable reserves are determined to exist. A review of each exploration licence or field is carried out, at least annually, to ascertain whether proved and/or probable reserves have been discovered.

Upon determination of proved and probable reserves, E&E assets attributable to those reserves are first tested for impairment at the CGU level, and then reclassified from E&E assets to property, plant and equipment.

*Development and production costs:*

Items of property, plant and equipment, which include oil and natural gas development and production (“D&P”) assets, are measured at cost less accumulated depletion and accumulated impairment losses. D&P assets are grouped into CGUs for impairment testing.

Expenditures on the construction, installation or completion of infrastructure facilities such as processing facilities, pipelines and the drilling of development wells, including unsuccessful development or delineation wells, are capitalized within D&P assets, as long as the facts and circumstances indicate that it is technically feasible and economically viable to extract identified reserves.

The initial cost of an asset is comprised of the purchase price or construction cost, any costs directly attributable to bringing the asset into operation, the initial estimate of the asset retirement obligation, and for qualifying assets, borrowing costs. The purchase price or constructed cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset.

Capitalized oil and natural gas interests generally represent costs incurred in developing proved and/or probable reserves and bringing in or enhancing production from such reserves, and are accumulated on a field or geotechnical area basis.

Exchanges of assets are measured at fair value unless the exchange transaction lacks commercial substance or the fair value of neither the asset received nor the asset given up is reliably measureable. The cost of the acquired asset is measured at the fair value of the asset given up, unless the fair value of the asset received is more clearly evident. Where fair value is not used, the cost of the acquired asset is measured at the carrying amount of the asset given up. The gain or loss on derecognition of the asset given up is recognized in earnings.

Gains and losses on disposal of an item of property, plant and equipment, including oil and natural gas interests, are determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment.

Other items of property, plant and equipment are carried at cost less accumulated depreciation and net accumulated impairment losses.

(ii) Subsequent costs:

Costs incurred subsequent to the determination of technical feasibility and commercial viability are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost can be measured reliably. The carrying amount of a replaced asset is derecognized when replaced. Routine repairs and maintenance costs are charged to earnings during the period in which they are incurred.

(iii) Depletion and depreciation:

The net carrying value of development or production assets is depleted using the unit of production method by reference to the ratio of production in the year to the related proved and probable reserves, taking into account estimated future development costs necessary to bring those reserves into production. Future development costs are estimated taking into account the level of development required to produce the reserves. These estimates are reviewed by independent reserve engineers on an annual basis. Major development projects are not depleted until production commences.

Proved and probable reserves are estimated using independent reserve engineer reports and represent the estimated quantities of crude oil, natural gas and natural gas liquids which geological, geophysical and engineering data demonstrate with a specified degree of certainty to be recoverable in future years from known reservoirs and which are considered commercially viable. There should be a 50 percent statistical probability that the actual quantity of recoverable reserves will be more than the amount estimated as proved and probable and a 50 percent statistical probability that it will be less. The equivalent statistical probabilities for the proved component of proved and probable reserves are 90 percent and 10 percent, respectively.

Such reserves may be considered commercially producible if management has the intention of developing and producing them and such intention is based upon:

- a reasonable assessment of the future economics of such production;
- a reasonable expectation that there is a market for all or substantially all the expected oil and natural gas production; and
- evidence that the necessary production, transmission and transportation facilities are available or can be made available.

Reserves may only be considered proved and probable if productibility is supported by either actual production or a conclusive formation test. The area of reservoir considered proved includes (a) that portion delineated by drilling and defined by gas-oil and/or oil-water contacts, if any, or both, and (b) the immediately adjoining portions not yet drilled, but which can be reasonably judged as economically productive on the basis of available geophysical, geological and engineering data. In the absence of information on fluid contacts, the lowest known structural occurrence of oil and natural gas controls the lower proved limit of the reservoir.

Routine turnarounds are depreciated and recognized in earnings over the period until the next turnaround is expected to be required. Turnarounds have an estimated life of two years and are depreciated over a two year life.

For other assets, depreciation is recognized in earnings on a declining balance basis at an annual rate of 20 percent over the estimated useful lives of each item of property, plant and equipment. Leased assets are depreciated over the shorter of the lease term and their useful lives unless it is reasonably certain that the Company will obtain ownership by the end of the lease term. Depreciation methods, useful lives and residual values are reviewed at each reporting date.

(d) Leased assets:

Leases where the Company assumes substantially all the risks and rewards of ownership are classified as finance leases. All other leases are classified as operating leases, which are not recognized on the Company's consolidated balance sheet. Zargon has no finance leases at this time.

Payments made under operating leases are recognized in earnings on a straight-line basis over the term of the lease. Lease incentives received are recognized as an integral part of the total lease expense, over the term of the lease.

(e) Business combinations and goodwill:

Business combinations are accounted for using the acquisition method. The cost of an acquisition is measured as the aggregate of the consideration transferred, measured at the acquisition date fair value and the amount of any non-controlling interest in the acquiree. For each business combination, Zargon measures the non-controlling interest in the acquiree either at fair value or at the proportionate share of the acquiree's identifiable net assets. Transaction costs associated with a business combination are expensed as incurred.

When Zargon acquires a business, it assesses the financial assets and liabilities assumed for appropriate classification and designation in accordance with the contractual terms, economic circumstances and pertinent conditions as at the acquisition date.

If the business combination is achieved in stages, the acquisition date fair value of Zargon's previously held equity interest in the acquiree is re-measured to fair value at the acquisition date through earnings as an impairment.

Any contingent consideration to be transferred by the acquirer will be recognized at fair value at the acquisition date. Subsequent changes to the fair value of the contingent consideration which is deemed to be an asset or liability will be recognized in accordance with IAS 39 "Financial Instruments: Recognition and Measurement" either in earnings or as a change to other comprehensive income. If the contingent consideration is classified as equity, it should not be re-measured until it is finally settled within equity.

Goodwill is initially measured at cost being the excess of the aggregate of the consideration transferred and the amount recognized for non-controlling interest over the net identifiable assets acquired and liabilities assumed. If this consideration is lower than the fair value of the net assets of the subsidiary acquired, the difference is recognized in earnings.

Subsequent to initial recognition, goodwill is measured at cost less any accumulated impairment losses. For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Company's CGUs that are expected to benefit from the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

Where goodwill forms part of a CGU and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the CGU retained.

(f) Impairment:

(i) Financial assets:

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between the amortized cost of the loan or receivable and the present value of the estimated future cash flows, discounted using the

instrument's original effective interest rate. The carrying amount of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.

All impairment losses are recognized in earnings.

An impairment loss on financial assets carried at amortized cost is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized. For financial assets measured at amortized cost, the reversal is recognized in earnings.

For available-for-sale financial investments, the impairment loss is calculated as the difference between the acquisition cost and the current fair value, less any impairment loss on that investment previously recognized in the statement of profit or loss is removed from other comprehensive income and recognized in the statement of profit or loss. Impairment losses on equity investments classified as available-for-sale are not reversed through profit or loss, any increases in their fair value after impairment is recognized in other comprehensive income.

(ii) Non-financial assets:

The carrying amounts of the Company's non-financial assets, other than E&E assets and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. These indicators include future prices, future cost and reserves value, but this list is not exhaustive. For goodwill, an impairment test is completed at least annually. E&E assets are assessed for impairment when they are reclassified to property, plant and equipment, as D&P assets, and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For the purpose of impairment testing, assets are grouped together into the smallest group of assets that generates cash flows that are largely independent of the cash flows of other assets or groups of assets (the CGU). The recoverable amount of an asset or a CGU is the greater of its value-in-use and its fair value less costs to sell.

Fair value is determined as the amount that would be obtained from the sale of the assets in an arm's length transaction between knowledgeable and willing parties. Fair value for oil and gas assets is generally determined as the present value of estimated future cash flows arising from the continued use of assets, which includes estimates such as the cost of future expansion plans and eventual disposal, using assumptions that an independent market participant may take into account. Cash flows are discounted to their present value using a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss is recognized if the carrying amount of an asset or CGU exceeds its recoverable amount. Impairment losses are recognized in earnings. Impairment losses recognized in respect of CGUs are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amounts of the other assets in the unit (group of units) on a pro rata basis.

An impairment loss in respect of goodwill is not reversed. In respect of other assets, impairment losses recognized in prior years are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depletion and depreciation, if no impairment loss had been recognized.

(g) Provisions:

A provision is recognized if, as a result of a past event, the Company has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Where the Company expects some or all of the provision to be reimbursed, for example under an insurance contract, the reimbursement is recognized as a separate asset but only when the reimbursement is virtually certain. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. Provisions are not recognized for future operating losses.

*Asset retirement obligations:*

The Company's activities give rise to dismantling, decommissioning and site restoration activities (often referred to as asset retirement obligations). A provision is made for the estimated cost of site restoration and capitalized in the relevant asset category. The capitalized amount is depleted on the unit of production method based on proved and probable reserves.

Asset retirement obligations are measured at the present value of management's best estimate of expenditures required to settle the present obligation at the balance sheet date. Subsequent to the initial measurement, the obligation is adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows or discount rate underlying the obligation. The increase in the provision due to the passage of time is recognized under finance costs as accretion whereas increases/decreases due to changes in the estimated future cash flows or the estimated discount rate are capitalized. Actual costs incurred upon settlement of the asset retirement obligations are charged against the provision to the extent the provision was established.

(h) Share-based payments:

Under the Company's share award and common share rights plans (the "Plans"), options to purchase common shares were granted to directors, officers, employees and other service providers at market prices. Share awards and options grants of the Company are measured at fair value at the date of grant and recognized as share-based compensation expense with a corresponding increase in contributed surplus. The total amount to be expensed is determined by reference to the fair value of the awards/options granted, excluding the impact of any non-market service and performance vesting conditions. Non-market vesting conditions are included in assumptions about the number of awards/options that are expected to vest. When awards/options vest in instalments over the vesting period, each instalment is accounted for as a separate arrangement. A forfeiture rate is estimated on the grant date and, at each reporting date, the Company revises its estimates of the number of awards/options that are expected to vest.

(i) Financial instruments:

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions that define the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership.

Financial assets and liabilities are offset and the net amount reported in the consolidated balance sheet when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

At initial recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instruments were acquired:

(i) Non-derivative financial instruments:

Non-derivative financial instruments comprise trade and other receivables, cash and cash equivalents, bank overdrafts, loans and borrowings, and trade and other payables. Non-derivative financial instruments are recognized initially at fair value plus, for instruments not at fair value through earnings, any directly attributable transaction costs. Subsequent to initial recognition non-derivative financial instruments are measured as described below.

Cash and cash equivalents:

Cash and cash equivalents comprise cash on hand, term deposits held with banks and other short term highly liquid investments with original maturities of three months or less. Bank overdrafts that are repayable on demand and form an integral part of the Company's cash management, whereby management has the ability and intent to net bank overdrafts against cash, are included as a component of cash and cash equivalents for the purpose of the consolidated statement of cash flows.

Financial assets at fair value through earnings:

An instrument is classified at fair value through earnings if it is held for trading or is designated as such upon initial recognition. Financial instruments are designated at fair value through earnings if the Company manages such investments and makes purchase and sale decisions based on their fair value in accordance with the Company's risk management or

investment strategy. Upon initial recognition, attributable transaction costs are recognized in earnings when incurred. These financial instruments are measured at fair value and changes therein are recognized in the consolidated statement of earnings/(loss) and comprehensive income/(loss). The Company's risk management contracts are derivatives classified as held for trading as discussed in part (ii) below. The Company has not designated any financial instruments at fair value through earnings.

Available-for-sale financial assets:

Equity investments classified as available-for-sale are those that are neither classified as held for trading nor designated at fair value through profit or loss. After initial measurement, available-for-sale financial investments are subsequently measured at fair value with unrealized gains or losses recognized in other comprehensive income and credited in the available-for-sale reserve until the investment is derecognized, at which time the cumulative gain or loss is recognized in other operating income, or the investment is determined to be impaired, when the cumulative loss is reclassified from the available-for-sale reserve to the statement of earnings/(losses).

Other:

Other non-derivative financial instruments, such as trade and other receivables, loans and borrowings and trade and other payables, are measured at amortized cost using the effective interest method, less any impairment losses.

(ii) Derivative financial instruments:

Derivative financial instruments are sometimes utilized to reduce commodity price risk associated with the Company's production of oil and natural gas. The base prices for the commodities are sometimes denominated in US dollars and the Company may also use such financial instruments to reduce the related foreign currency risk. Financial instruments may also be used from time to time to reduce interest rate risk on outstanding debt. The Company does not enter into financial instruments for trading or speculative purposes.

The Company follows a policy of using risk management instruments such as fixed price swaps, forward sales, puts and costless collars. The objective is to partially offset or mitigate the wide price swings commonly encountered in oil and natural gas commodities and in so doing protect a minimum level of cash flow.

Interest rate swaps are utilized to hedge interest on long term debt to manage the Company's exposure to rate fluctuations, which impact finance expenses.

Electricity price contracts are sometimes utilized to hedge anticipated purchases of electricity to manage the Company's exposure to price fluctuations, which impact operating expenses.

The Company considers these financial risk management contracts to be effective on an economic basis but has decided not to designate these contracts as hedges for accounting purposes and, accordingly, for outstanding contracts not designated as hedges, an unrealized gain or loss is recorded based on the change in fair value ("mark-to-market") of the contracts at each reporting period end. These instruments have been recorded as derivative financial instruments in the consolidated balance sheet.

In the case of forward sales, the instrument can sometimes be satisfied by physical delivery. In the case of physical delivery, the payment/receipt is recorded as part of the normal revenue stream.

Foreign currency collar and swap agreements are utilized to manage the risk inherent in producing commodities whose price is based directly or indirectly on US dollars, using notional principal amounts equal to the projected monthly revenue from their sale. Payments or charges are calculated and paid according to the terms of the agreement, typically with monthly settlement.

(j) Income tax:

Income tax expense comprises current and deferred tax. Income tax expense is recognized in earnings except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized using the consolidated balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized on the initial recognition of assets or liabilities in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but the Company intends to settle current tax liabilities and assets on a net basis or the tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized. Deferred tax assets and liabilities are presented as non-current.

(k) Revenue:

Revenue from the sale of crude oil, natural gas and natural gas liquids is recorded when the significant risks and rewards of ownership of the product is transferred to the buyer, which is usually when legal title passes to an external party. This is generally at the plant gate, which is the pipeline delivery point for natural gas and at the contracted delivery point for crude oil. Revenue is measured net of discounts, customs, duties and royalties. With respect to the latter, the entity is acting as a collection agent on behalf of others.

Tariffs and tolls charged to other entities for use of pipelines and facilities owned by the Company are recognized as revenue as they accrue in accordance with the terms of the service or tariff and tolling agreements.

Royalty income is recognized as it accrues in accordance with the terms of the overriding royalty agreements and is included in revenue.

(l) Finance expenses:

Finance expenses comprise interest expense on borrowings and convertible debentures and accretion of the discount on asset retirement obligations and convertible debentures.

Borrowing costs, which consist of interest expense incurred for the construction of qualifying assets, are capitalized during the period of time that is required to complete and prepare the assets for their intended use or sale. All other borrowing costs are recognized in profit or loss using the effective interest method. The capitalization rate used to determine the amount of borrowing costs to be capitalized is the weighted average interest rate applicable to the Company's outstanding borrowings during the period.

Interest income is recognized as it accrues in earnings using the effective interest method.

(m) Earnings per share:

Basic earnings per share is calculated by dividing net earnings for the period by the weighted average number of common shares outstanding during the period. Diluted earnings per share is calculated by dividing the net earnings by the weighted average number of common shares outstanding during the year plus the weighted average number of common shares that would be issued if all the dilutive potential common shares were converted into common shares. The dilutive potential common shares consist of share-based compensation awards for which dilution is determined by assuming that the proceeds received from "in-the-money" common share rights and unrecognized future share-based compensation expense are used to repurchase common shares at the average market rate during the period. The convertible debentures could also potentially dilute basic earnings per share.

(n) Cash dividends:

The Company declares monthly dividends of cash to shareholders of record on the last day of each calendar month. Pursuant to the Company's policy, it will pay dividends to its shareholders subject to satisfying its financing covenants and the requirements of the *Business Corporation Act* (Alberta). Such dividends are recorded as distributions of equity upon declaration of the dividend.

(o) Segment reporting:

Operating segments are reported in a manner consistent with the internal reporting provided to the Chief Operating Decision-Maker. The Chief Operating Decision-Maker, who is responsible for allocating resources and assessing performance of the operating segments, has been identified as the Chief Executive Officer.

An operating segment is a component of the Company that engages in business activities from which it may earn revenue and incur expenses, including revenue and expenses that relates to transactions with any of the Company's other components.

Segment results that are reported directly to the Chief Operating Decision-Maker include items directly attributable to a segment as well as results that have been allocated on a reasonable basis.

(p) Changes in accounting policy and disclosure

(i) New and amended standards adopted by the Company for the year ended December 31, 2014:

- IAS 36 "Impairment of Assets" has been amended to require additional disclosures in the event of recognizing an impairment of assets. The retrospective application of this standard is required to be adopted for periods on or after January 1, 2014. The amendment did not have a significant impact on the Company's consolidated financial statements.
- IFRIC 21 "Levies" clarifies that an entity recognizes a liability for a levy when the activity that triggers payment, as identified by the relevant legislation, occurs. The interpretation also clarifies that no liability should be recognized before the specified minimum threshold to trigger that levy is reached. IFRIC 21 is required to be adopted retrospectively for fiscal years beginning January 1, 2014, with earlier adoption permitted. The adoption of this IFRIC did not have an impact on the Company's consolidated financial statements.

(ii) Standards, amendments and interpretations to existing standards that are not yet effective and have not been early adopted by the Company:

- IFRS 9 "Financial Instruments" replaces the current multiple classification and measurement models for financial assets and liabilities with a single model. IFRS 9 also details the new general hedge accounting model. Hedge accounting remains optional and the new model is intended to allow reporters to better reflect risk management activities in the financial statements and provide more opportunities to apply hedge accounting. The Company does not employ hedge accounting for its risk management contracts currently in place. IFRS 9 will be effective for annual periods beginning on or after January 1, 2018, with early adoption permitted. The Company has not yet determined the impact on the Company's consolidated financial statements.
- IFRS 15 "Revenue from Contracts with Customers" specifies how and when to recognize revenue as well as requiring entities to provide users of financial statements with more informative, relevant disclosures. The standard supersedes IAS 18 "Revenue", IAS 11 "Construction Contracts" and a number of revenue-related interpretations. IFRS 15 will be effective for annual periods beginning on or after January 1, 2017 with early adoption permitted. The Company has not yet determined the impact on the Company's consolidated financial statements.

## 5. PROPERTY, PLANT AND EQUIPMENT

(\$ thousands)	2014	2013
Cost, beginning of year	580,267	535,791
Accumulated depletion and depreciation, beginning of year	(171,548)	(145,820)
Net carrying amount, beginning of year	408,719	389,971
Additions	71,581	74,600
Disposals	(30,959)	(31,871)
Acquisition of property, plant and equipment	2,348	–
Change in asset retirement obligation	(51,633)	23,285
Assets transferred from intangible exploration and evaluation assets	79	25
Impairment loss on property, plant and equipment	(20,764)	(4,393)
Exchange differences	2,890	2,459
Depletion and depreciation	(44,816)	(45,357)
Net carrying amount, end of year	337,445	408,719
Cost, end of year	519,076	580,267
Accumulated depletion and depreciation, end of year	(181,631)	(171,548)
Net carrying amount, end of year	337,445	408,719

### (a) Depletion, Depreciation and Impairment charge:

The depletion, depreciation and impairment of property, plant and equipment, and any eventual reversal thereof, are recognized in depletion and depreciation and impairment loss in the consolidated statement of earnings/(loss) and comprehensive income/(loss) (see also Note 7).

Property, plant and equipment are not depleted and depreciated for major development projects until production commences. For the year ended December 31, 2014, nil (2013 – \$42.45 million) of major development project property was not depleted or depreciated.

### (b) Security:

At December 31, 2014 and 2013, a \$300 million demand debenture on assets of the Company has been provided as security for the Company's syndicated committed credit facilities.

### (c) Contingencies:

Although the Company believes that it has title to its oil and natural gas properties, it cannot control or completely protect itself against the risk of title disputes or challenges.

For the year ended December 31, 2014, \$0.35 million (2013 – \$0.34 million) of direct and incremental general and administrative expenses were capitalized to property, plant and equipment.

For the year ended December 31, 2014, the Company disposed of certain assets for gross cash proceeds of \$31.10 million (2013 – \$31.91 million), resulting in a gain of \$11.81 million (2013 – \$1.73 million loss).

In June 2014, the Company closed a property acquisition in the Alberta Plains South area. The property acquisition was accounted for as a business combination under IFRS 3. Consideration paid consisted of \$3.11 million of cash in exchange for property, plant and equipment, exploration and evaluation assets, goodwill and decommissioning obligations.

## 6. INTANGIBLE EXPLORATION AND EVALUATION ASSETS AND GOODWILL

(\$ thousands)	Goodwill	E&E assets	Total
Cost:			
Balance at December 31, 2012	2,969	19,968	22,937
Additions	–	349	349
Disposal	–	(3,033)	(3,033)
Transfers to property, plant and equipment	–	(25)	(25)
Exploration and evaluation expense	–	(4,013)	(4,013)
Exchange differences	–	85	85
Balance at December 31, 2013	<b>2,969</b>	<b>13,331</b>	<b>16,300</b>
Additions	–	415	415
Disposals	–	(5,922)	(5,922)
Acquisition	1,801	30	1,831
Transfers to property, plant and equipment	–	(79)	(79)
Exploration and evaluation expense	–	(1,267)	(1,267)
Exchange differences	–	102	102
Balance at December 31, 2014	<b>4,770</b>	<b>6,610</b>	<b>11,380</b>

Exploration and evaluation assets consist of the Company's undeveloped land which are pending the determination of proved or probable reserves. Additions represent the Company's share of costs incurred on E&E assets during the year.

### (a) Impairment charge:

The impairment of intangible exploration assets and intangible assets, and any eventual reversals therefore, and goodwill, are recognized as impairment expense in the consolidated statement of earnings/(loss) and comprehensive income/(loss). There was no impairment of exploration and evaluation assets or goodwill during the year. Goodwill is allocated to two CGUs.

### (b) Recoverability of exploration and evaluation assets:

The Company assesses the recoverability of intangible E&E assets, before and at the moment of reclassification to property, plant and equipment, at the CGU level. The CGU includes both E&E assets and D&P assets for the relevant area, but is not larger than an operating segment.

## 7. IMPAIRMENT LOSS

As at December 31, 2014, the Company tested its CGUs, as defined under IFRS, for impairment. Low crude oil and natural gas prices resulted in impairment of three CGUs, Alberta Plains South, Williston Basin Canada and Williston Basin USA. The E&E assets associated with these CGUs were not included in this impairment test and were tested separately.

The recoverable amount of the CGUs was estimated based on their fair value less costs to sell. The estimate of fair value less costs to sell was determined using an after-tax discount rate of 11 percent and forecasted cash flows. The forecasted cash flows are prepared over the estimated life of the reserves in the CGUs. The prices used to estimate the fair value less cost to sell are those used by McDaniel and Associates Consultants Ltd., our independent reserve engineers.

The following commodity price estimates were used to determine the recoverable amount:

Year	WTI Oil (\$US/bbl) <sup>(1)</sup>	AECO Gas (\$Cdn/mmbtu) <sup>(1)</sup>	\$US/\$Cdn Exchange Rates <sup>(1)</sup>
2015	65.00	3.50	0.860
2016	75.00	4.00	0.860
2017	80.00	4.25	0.860
2018	84.90	4.50	0.860
2019	89.30	4.70	0.860
2020	93.80	5.00	0.860
2021	95.70	5.30	0.860
2022	97.60	5.50	0.860
2023	99.60	5.70	0.860
2024	101.60	5.90	0.860
2025	103.60	6.00	0.860
2026	105.70	6.10	0.860
2027	107.80	6.25	0.860
2028	110.00	6.35	0.860
2029	112.20	6.50	0.860
Remainder <sup>(2)</sup>	2.0%	2.0%	0.860

(1) Source: McDaniel & Associates Consultants Ltd. price forecast effective January 1, 2015.

(2) Percentage change represents the change in each year after 2029 to the end of the reserve life.

Based on the assessment on December 31, 2014, the carrying amount of the three CGUs were determined to be \$20.76 million higher than their recoverable amount, and an impairment loss was recognized. The carrying amounts before impairment were \$162.77 million, \$99.56 million and \$46.43 million for the Alberta Plains South, Williston Basin Canada and Williston Basin USA CGUs, respectively. In 2013, the Company determined there was \$4.39 million in impairment. No impairment losses from prior years were reversed in 2014.

The above estimates are particularly sensitive in the following areas:

- A one percent increase in the discount rate used would have increased the impairment loss by \$16.99 million.
- A five percent decrease in future planned cash flows would have increased the impairment loss by \$14.40 million.

## 8. CASH DIVIDENDS

During the year, the Company declared dividends to the shareholders in the aggregate amount of \$21.70 million (2013 – \$21.61 million) in accordance with the following schedule:

<b>2014 Dividends</b>	<b>Record Date</b>	<b>Dividend Date</b>	<b>Per Common Share</b>
January	January 31, 2014	February 18, 2014	\$0.06
February	February 28, 2014	March 17, 2014	\$0.06
March	March 31, 2014	April 15, 2014	\$0.06
April	April 30, 2014	May 15, 2014	\$0.06
May	May 31, 2014	June 16, 2014	\$0.06
June	June 30, 2014	July 15, 2014	\$0.06
July	July 31, 2014	August 15, 2014	\$0.06
August	August 31, 2014	September 15, 2014	\$0.06
September	September 30, 2014	October 15, 2014	\$0.06
October	October 31, 2014	November 17, 2014	\$0.06
November	November 30, 2014	December 15, 2014	\$0.06
December	December 31, 2014	January 15, 2015	\$0.06

During the fourth quarter of 2014, the Company announced a revised monthly dividend policy in which the dividend will be reduced from \$0.06 to \$0.03 per common share commencing in the first quarter of 2015.

Subsequent to the end of the period and prior to the consolidated financial statements being authorized for issue on March 10, 2015, the Company declared dividends of \$0.91 million or \$0.03 per common share for each of January and February of 2015.

<b>2013 Dividends <sup>(1)</sup></b>	<b>Record Date</b>	<b>Dividend Date</b>	<b>Per Common Share</b>
January	January 31, 2013	February 15, 2013	\$0.06
February	February 28, 2013	March 15, 2013	\$0.06
March	March 31, 2013	April 15, 2013	\$0.06
April	April 30, 2013	May 15, 2013	\$0.06
May	May 31, 2013	June 17, 2013	\$0.06
June	June 30, 2013	July 15, 2013	\$0.06
July	July 31, 2013	August 15, 2013	\$0.06
August	August 31, 2013	September 16, 2013	\$0.06
September	September 30, 2013	October 15, 2013	\$0.06
October	October 31, 2013	November 15, 2013	\$0.06
November	November 30, 2013	December 16, 2013	\$0.06
December	December 31, 2013	January 15, 2014	\$0.06

(1) The 2013 cash dividends include a non-cash equity issuance amount of \$1.26 million for the Dividend Reinvestment Plan which was suspended September 2013.

## 9. PROVISIONS

(\$ thousands)	Asset retirement obligations	Other	Total
Balance at December 31, 2013	135,177	399	135,576
Provisions made during the year	1,007	–	1,007
Foreign exchange and other	662	–	662
Provisions used during the year	(2,654)	(14)	(2,668)
Provisions related to dispositions	(35,225)	–	(35,225)
Provision related to acquisition	1,068	–	1,068
Revisions to estimated provisions	(17,415)	–	(17,415)
Accretion	3,937	–	3,937
Balance at December 31, 2014	86,557	385	86,942
Current	–	385	385
Non-current	86,557	–	86,557

(\$ thousands)	Asset retirement obligations	Other	Total
Balance at December 31, 2012	112,283	881	113,164
Provisions made during the year	1,248	–	1,248
Foreign exchange and other	595	–	595
Provisions used during the year	(3,788)	(482)	(4,270)
Provisions related to dispositions	(12,814)	–	(12,814)
Revisions to estimated provisions	34,851	–	34,851
Accretion	2,802	–	2,802
Balance at December 31, 2013	135,177	399	135,576
Current	–	399	399
Non-current	135,177	–	135,177

### Asset retirement obligations:

The Company's asset retirement obligation results from net ownership interests in petroleum and natural gas assets, including well sites, gathering systems and processing facilities. Zargon estimates the undiscounted value of its total asset retirement obligations to be \$98 million as at December 31, 2014. These obligations are expected to be incurred over the next 55 years. The asset retirement obligation is calculated using a discount factor being the risk-free rate related to the liability and is based on the Government of Canada long term bond rate. At the end of the fourth quarter of 2014, the discount factor of 3.25 percent was decreased to 2.50 percent based on the Government of Canada long term bond rate. Accordingly, Zargon recorded an adjustment to property, plant and equipment and the asset retirement obligation. An inflation rate of two percent per annum used in the calculation of the present value of the asset retirement obligation remains unchanged.

### Other:

Zargon is subject to normal course income tax audits by Canadian and US taxation authorities. During the fourth quarter of 2010, the Canada Revenue Agency commenced a flow-through share audit of a predecessor company from a prior corporate acquisition. In the first quarter of 2011, Zargon recorded a \$1.27 million provision which was comprised of a \$0.92 million charge to current income tax expense and a \$0.35 million charge to interest expense for the related Part XII.6 tax, with respect to this ongoing flow-through share audit. The interest expense related to the Part XII.6 tax has been paid to the Canada Revenue Agency and the remaining provision is currently \$0.39 million.

## 10. LONG TERM BANK DEBT

On June 13, 2014, Zargon amended and renewed its syndicated credit facilities, the result of which was the reduction of the available facilities and borrowing base to \$150 million. The syndicated committed credit facilities were reduced to \$140 million after the Company's semi-annual review was completed on November 10, 2014 and were reduced to \$130 million on December 16, 2014 after the disposition of assets. A \$300 million demand debenture on the assets of the Company has been provided as security for these facilities. The facilities are fully revolving for a 364 day period with the provision for an annual extension at the option of the lenders and upon notice from Zargon's Management. The next renewal date is June 24, 2015. Should the facilities not be renewed, they convert to one year non-revolving term facilities at the end of the revolving 364 day period. Repayment would not be required until the end of the non-revolving term, and, as such, these facilities have been classified as long term debt.

Interest rates fluctuate under the syndicated facilities with Canadian prime, US prime and US base rates plus an applicable margin between 50 basis points and 200 basis points as well as with Canadian banker's acceptance and LIBOR rates plus an applicable margin between 200 basis points and 350 basis points. At December 31, 2014, \$42.77 million (December 31, 2013 - \$39.97 million) had been drawn on the syndicated committed credit facilities with any unused amounts subject to standby fees. In the normal course of operations Zargon enters into various letters of credit. At December 31, 2014, the approximate value of outstanding letters of credit totalled \$0.90 million (December 31, 2013 - \$0.87 million). The letters of credit reduce the amount of Zargon's available credit facilities to \$86.33 million at December 31, 2014 (December 31, 2013 - \$124.16 million).

Zargon reviews its compliance with its bank debt covenants on a quarterly basis and is in compliance as at December 31, 2014.

## 11. CONVERTIBLE DEBENTURES

On May 1, 2012, Zargon completed the issuance of convertible unsecured subordinated debentures for gross proceeds of \$50.00 million (net proceeds of \$47.45 million after transaction costs) at a price of \$1,000 per debenture. On May 4, 2012, Zargon completed the issuance of the over-allotment of the convertible unsecured subordinated debentures for gross proceeds of \$7.50 million (net proceeds of \$7.20 million) at a price of \$1,000 per debenture. The debentures bear interest at a rate of six percent per annum, which is payable semi-annually, in arrears, on June 30 and December 31 of each year which commenced December 31, 2012. The debentures mature on June 30, 2017 and can be converted into common shares of Zargon at the option of the holders at a conversion price of \$18.80 per common share.

After June 30, 2015, Zargon may redeem the debentures in whole or in part provided the common shares' weighted average trading price during a specified period prior to redemption is not less than 125 percent of the conversion price.

The debentures have been classified as debt, net of issuance costs with the residual value allocated to shareholders' equity. The issuance costs will be amortized over the term of the debentures and the debt portion will accrete up to the principal balance at maturity. The accretion of the convertible debentures and the interest paid are expensed on the consolidated statements of earnings/(loss) and comprehensive income/(loss).

(\$ thousands)	December 31, 2014	December 31, 2013
Principal, end of year	<b>57,500</b>	57,500
Debt component, beginning of year	<b>52,478</b>	51,261
Accretion of convertible debentures	<b>1,257</b>	1,217
Debt component, end of year	<b>53,735</b>	52,478
Equity component, end of year	<b>3,640</b>	3,640

## 12. CAPITAL DISCLOSURES

The Company's capital structure is comprised of shareholders' equity plus long term bank debt and convertible debentures. The Company's objectives when managing its capital structure are to:

- a) Maintain financial flexibility so as to preserve Zargon's access to capital markets and its ability to meet its financial obligations; and
- b) Finance internally generated growth as well as acquisitions.

The Company monitors its capital structure and short term financing requirements using a non-GAAP financial metric, which is the ratio of debt net of working capital ("net debt") to funds flow from operating activities. Net debt, as used by Zargon, is calculated as bank debt plus the full future face value of the convertible debenture of \$57.50 million and any working capital deficit excluding the unrealized derivative assets/liabilities. Funds flow from operating activities represent net earnings/loss and asset retirement expenditures except for non-cash items. The metric is used to steward the Company's overall debt position as a measure of the Company's overall financial strength and is calculated as follows:

(\$ thousands, except ratio)	December 31, 2014	December 31, 2013
Net debt	113,429	116,238
Funds flow from operating activities	50,674	58,481
Net debt to funds flow from operating activities ratio	2.24	1.99

As at December 31, 2014, Zargon's net debt to funds flow from operating activities ratio was 2.24, an increase from 1.99 at December 31, 2013. Bank debt levels decreased during the year as a result of property dispositions, which were offset by the 2014 drilling program and ASP chemical and capital expenditures. On June 13, 2014, Zargon amended and renewed its syndicated credit facilities, the result of which was the reduction of the available facilities and borrowing base to \$150 million. The syndicated committed credit facilities were reduced to \$140 million after the Company's semi-annual review was completed on November 10, 2014 and were reduced to \$130 million on December 16, 2014 after the disposition of assets. The next renewal date is June 24, 2015. These facilities continue to be available for general corporate purposes and the potential acquisition of oil and natural gas properties.

To manage its capital structure, the Company may adjust capital spending, adjust dividends paid to shareholders, issue new shares, issue new debt or repay existing debt.

The Company's capital management objectives, evaluation measures, definitions and targets have remained unchanged over the periods presented. Zargon reviews its compliance with its bank debt covenants on a quarterly basis and is in compliance as at December 31, 2014.

## 13. SHARE CAPITAL

The Company is authorized to issue an unlimited number of voting common shares and 10,000,000 preferred shares.

### Common Shares

(thousands)	December 31, 2014	
	Number of Shares	Amount (\$)
Balance, as at December 31, 2013	30,087	256,092
Share awards exercised	92	-
Share-based compensation transferred from contributed surplus on exercise of share awards	-	1,046
Balance, as at December 31, 2014	30,179	257,138

**Common Shares**

December 31, 2013

(thousands)	Number of Shares	Amount (\$)
Balance, as at December 31, 2012	29,868	254,400
Share awards exercised	28	–
Share-based compensation transferred from contributed surplus on exercise of share awards	–	432
Issued pursuant to the Dividend Reinvestment Plan	191	1,260
Balance, as at December 31, 2013	30,087	256,092

Zargon had a Dividend Reinvestment Plan (“DRIP”) in place in conjunction with the Company’s transfer agent to provide the option for shareholders to reinvest cash dividends into common shares issued from treasury at a five percent discount to the prevailing market price. The DRIP was suspended starting with the September 2013 dividend paid on October 15, 2013.

**14. SHARE-BASED PAYMENTS****Share Award Plan**

Under the Share Award Plan, directors, officers, employees and other service providers (the “grantees”) are granted the right to receive a defined number of shares in the future, which increases commensurately with each dividend declared by the Company after the grant date. The grantees will receive equity compensation in relation to the value of a specified number of underlying share awards. The awards vest equally over four years and expire five years after grant date. Holders may choose to exercise upon vesting or at any time thereafter, with forfeiture of any shares not exercised by the expiry date. Upon vesting, the grantees are eligible to receive a share award based on the fair value of the underlying share awards plus all notional dividends accrued since the grant date. Zargon uses a fair value methodology to value the share awards.

Due to the nature of the plan, Zargon is required to estimate the forfeiture rate upon initial calculation of fair values. The forfeiture rate is estimated at 14 percent while the interest rate and volatility is set at a historical rate as there is no exercise price. The fair value of the share award is determined on the grant date at the prior day closing price of the Company’s common shares on the Toronto Stock Exchange.

The following table summarizes information about the Company’s share awards under the Share Award Plan:

	December 31, 2014	December 31, 2013
	Number of Share Awards (thousands)	Number of Share Awards (thousands)
Outstanding at beginning of year	563	322
Share awards granted	305	318
Share awards exercised	(91)	(28)
Share awards forfeited	(99)	(49)
Outstanding at end of the year	678	563
Share awards exercisable at end of year	156	88

**Common Share Rights Incentive Plans**

Under these plans, directors, officers, employees and other service providers of the Company possess rights to acquire common shares at their option of either the original exercise price or a “modified price” as calculated per the provisions of the relevant plan. The Common Share Rights Incentive Plan (2007) (the “Old Plan”) expired in the first quarter of 2013. Under the Common Share Rights Incentive Plan (2009) (the “New Plan”), if the monthly dividend exceeds the monthly return of 0.833 percent of the Company’s recorded net book value of oil and natural gas properties (as defined under the New Plan), the entire amount of the dividend is deducted from the original grant price. Options granted under either Plan generally vest equally over a three-year period and expire approximately five years from the grant date. Zargon uses a fair value methodology to value the option grants.

The following table summarizes information about the Company's share rights under the Old Plan:

	December 31, 2014		December 31, 2013	
	Number of Share Options (thousands)	Weighted Average Exercise Price Initial and Modified (\$/share)	Number of Share Options (thousands)	Weighted Average Exercise Price Initial and Modified (\$/share)
Outstanding at beginning of year	–	–	170	23.23 / 21.40
Share options expired	–	–	(170)	23.23
Outstanding at end of the year	–	–	–	–
Share rights exercisable at end of year	–	–	–	–

The following table summarizes information about the Company's share options under the New Plan:

	December 31, 2014		December 31, 2013	
	Number of Share Options (thousands)	Weighted Average Exercise Price Initial and Modified (\$/share)	Number of Share Options (thousands)	Weighted Average Exercise Price Initial and Modified (\$/share)
Outstanding at beginning of year	391	18.06 / 14.39	458	18.08 / 14.44
Share options expired	(173)	15.89	–	–
Share options forfeited	(40)	19.67	(67)	18.14
Outstanding at end of the year	178	19.80 / 16.85	391	18.06 / 14.39
Share rights exercisable at end of year	178	19.80 / 16.85	391	18.06 / 14.39

The following tables summarize information about share rights outstanding at December 31, 2014:

For the New Plan at the initial grant price:

Range of Exercise Prices (\$/share option)	Share Options Outstanding			Share Options Exercisable	
	Number Outstanding (thousands)	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price (\$/share option)	Number Exercisable (thousands)	Weighted Average Exercise Price (\$/share option)
17.70 – 19.85	178	0.1 years	19.80	178	19.80

For the New Plan at the modified price:

Range of Exercise Prices (\$/share option)	Share Options Outstanding			Share Options Exercisable	
	Number Outstanding (thousands)	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price (\$/share option)	Number Exercisable (thousands)	Weighted Average Exercise Price (\$/share option)
15.73 – 16.88	178	0.1 years	16.85	178	16.85

### Share-Based Compensation

The share awards for the year ended December 31, 2014, together with the continued vesting of options granted in prior years, resulted in share-based compensation expense in 2014 of \$1.50 million (2013 – \$1.72 million).

Compensation expense associated with awards/options granted under each Plan is recognized in earnings over the vesting period of the Plan with a corresponding increase in contributed surplus. The exercise of awards/options is recorded as an increase in common shares with a corresponding reduction in contributed surplus.

## 15. FINANCIAL INSTRUMENTS

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates cannot be determined with precision as they are subjective in nature and involve uncertainties and matters of judgement.

The following table shows the comparison of the carrying and fair value of the company's financial instruments:

(thousands)	December 31, 2014		December 31, 2013	
	Carrying Amount (\$)	Fair Value (\$)	Carrying Value (\$)	Fair Value (\$)
<b>Loans and receivables:</b>				
Trade and other receivables	11,240	11,240	14,087	14,087
<b>Fair value through profit and loss:</b>				
Derivative assets	12,004	12,004	22	22
Derivative liabilities	197	197	5,210	5,210
<b>Fair value through other comprehensive income:</b>				
Investment in marketable securities	1,542	1,542	800	800
<b>Other liabilities:</b>				
Trade and other payables	24,971	24,971	32,450	32,450
Cash dividends	1,811	1,811	1,805	1,805
Long term bank debt	42,770	42,770	39,968	39,968
Convertible debentures	53,735	50,939	52,478	56,638

### Determination of Fair Value

The Company's investment in marketable securities and risk management contracts have been assessed on the fair value hierarchy described in Note 3(iv) and are classified as Level I and Level II, respectively. Assessment of the significance of a particular input into the fair value measurement requires judgment and may affect the placement within the fair value hierarchy level. The Company's policy is to recognize transfers into and out of fair value hierarchy levels as of the date of the event or change in circumstances that caused the transfer. The company does not have any fair value measurements classified as Level III.

At each reporting date, the Company determines whether transfers have occurred between levels in the hierarchy by reassessing the level of classification for each financial asset and financial liability measured or disclosed at fair value in the financial statements. Assessment of the significance of a particular input to the fair value measurement requires judgement and may affect the placement within the fair value hierarchy. During the year ended December 31, 2014, there were no transfers between levels I, II, or III.

The carrying value of receivables and other liabilities approximate their fair value due to their short maturities, except for the convertible debentures which is determined using Level I inputs.

### Financial Risk Management

The Company is exposed to financial risks arising from its financial assets and liabilities. The financial risks include market risk (commodity prices, interest rates and foreign exchange rates), credit risk and liquidity risk.

- Market Risk

Market risk is the risk that the fair value of future cash flows of financial assets or liabilities will fluctuate due to movements in market prices and is comprised of the following:

- Commodity Price Risk

Commodity price risk is the risk that the fair value of future cash flows will fluctuate as a result in changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian and United States dollar, but also world economic events that dictate the levels of supply and demand. As a means of mitigating exposure to commodity price risk volatility, the Company has entered into various derivative agreements. The use of

derivative instruments is governed under formal policies and is subject to limits established by the Board of Directors. The Company's policy is to not use derivative financial instruments for speculative purposes.

Natural Gas – To partially mitigate the natural gas commodity price risk, the Company has entered into swaps, which fix the Canadian dollar AECO prices and a natural gas basis hedge.

Crude Oil – The Company has partially mitigated its exposure to the WTI NYMEX price with fixed price swaps.

#### - Interest Rate Risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. Borrowings under bank credit facilities are market rate based (variable interest rates); thus, carrying values approximating fair values.

At the December 31, 2014 debt pricing levels, the increase or decrease in net earnings for the year for each one percent change in interest rates would amount to \$0.55 million (2013 - \$0.42 million) before swaps.

#### - Foreign Exchange Risk

Foreign currency exchange rate risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in foreign exchange rates. The underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. As Zargon operates in North America, fluctuations in the exchange rate between the US/Canadian dollar can have a significant effect on the Company's reported results. A \$0.01 change in the US to Canadian dollar exchange rate would have resulted in a \$0.67 million (2013 - \$0.81 million) increase or decrease in net earnings for the year ended December 31, 2014. In order to mitigate the Company's exposure to foreign exchange fluctuations, the Company may enter into foreign exchange derivative agreements.

- Credit Risk

Credit risk is the risk that the counterparty to a financial asset will default, resulting in the Company incurring a financial loss. This credit exposure is mitigated with credit practices that limit transactions according to counterparties' credit quality. A substantial portion of the Company's accounts receivable are with customers in the oil and natural gas industry and are subject to normal industry credit risks.

The maximum credit risk exposure associated with accounts receivable and derivative assets is the total carrying value. The Company monitors these balances monthly to limit the risk associated with collection. Of Zargon's accounts receivable at December 31, 2014, approximately 50 percent (December 31, 2013 – 58 percent) was owing from two companies and Zargon anticipates full collection.

The Company's allowance for doubtful accounts at December 31, 2014 was \$0.35 million (December 31, 2013 – \$0.26 million). During 2014, the Company recorded an additional \$0.09 million of provisions for non-collectible accounts receivable.

When determining whether amounts that are past due are collectible, management assesses the credit worthiness and past payment history of the counterparty, as well as the nature of the past due amount. Zargon considers all material amounts greater than 90 days to be past due. As at December 31, 2014, \$0.37 million of accounts receivable are past due, excluding amounts described above, all of which are considered to be collectable.

- Liquidity Risk

Liquidity risk is the risk the Company will encounter difficulties in meeting its financial liability obligations. The Company manages its liquidity risk through funds flow and debt management. See Note 12 for a more detailed discussion.

As at December 31, 2014, Zargon had available unused committed bank credit facilities of approximately \$86.33 million compared to \$124.16 million at December 31, 2013. The Company believes it has sufficient funding through the use of these facilities to meet foreseeable borrowing requirements.

The timing of cash outflows relating to financial liabilities are outlined in the table below:

(\$ thousands)	1 year	2–3 years	Total
Trade and other payables	24,971	–	24,971
Cash dividends payable	1,811	–	1,811
Derivative liabilities	122	75	197
Long term bank debt	–	42,770	42,770
Interest on convertible debentures	3,450	5,175	8,625
Convertible debentures <sup>(1)</sup>	–	57,500	57,500

(1) Amount is the full face value of the convertible debentures at \$57.50 million.

### Commodity Price Sensitivities

The following summarizes the sensitivity of the fair value of the Company's risk management positions to fluctuations in commodity prices, with all other variables held constant. When assessing the potential impact of these commodity price changes, the Company believes 10 percent volatility is a reasonable long term measure.

Fluctuations of 10 percent in commodity prices could have resulted in unrealized gains or losses for risk management contracts impacting net earnings/losses of \$1.59 million (2013 – \$10.83 million) for oil and \$0.08 (2014 – nil) for natural gas.

### 16. DERIVATIVES

The Company is a party to certain financial instruments that have fixed the price of a portion of its oil production and interest rates. The Company enters into these contracts for risk management purposes only in order to protect a portion of its future cash flows from the volatility of oil and natural gas commodity prices and interest rates. For financial risk management contracts, the Company considers these contracts to be effective on an economic basis but has decided not to designate these contracts as hedges for accounting purposes and, accordingly, any unrealized gains or losses are recorded in earnings based on the fair value (mark-to-market) of the contracts at each reporting period. The unrealized gain on the statement of earnings/(loss) and comprehensive earnings/(loss) for 2014 was \$17.00 million and the unrealized loss for 2013 was \$9.72 million. The realized loss on the statement of earnings/(loss) and comprehensive earnings/(loss) for 2014 was \$2.59 million and the realized loss for 2013 was \$0.46 million.

As at December 31, 2014, the Company had the following outstanding commodity and interest risk management contracts:

#### Commodity Financial Risk Management Contracts:

	Rate	Weighted Average Price	Range of Terms	Fair Market Value Asset (\$ thousands)
Oil swaps	400 bbl/d	\$91.73 US/bbl	Jan. 1/15 – Mar. 31/15	1,600
	1,200 bbl/d	\$94.01 US/bbl	Jan. 1/15 – Jun. 30/15	10,032
Natural gas swaps	3,000 gj/d	\$4.18 Cdn/gj	Jan. 1/15 – Mar. 31/15	372
<b>Total Fair Market Value, Commodity Price Financial Contracts</b>				<b>12,004</b>

Oil swaps are settled against the NYMEX WTI pricing index, whereas natural gas swaps are settled against the AECO pricing index.

#### Interest Rate Risk Management Contracts:

	Notional Value	Interest Rate <sup>(1)</sup>	Range of Terms	Fair Market Value Liability (\$ thousands)
Interest rate swaps	\$20,000,000/month	1.640%	Jan. 1/15 – Jul. 26/16	(81)
	\$20,000,000/month	1.731%	Jan. 1/15 – Aug. 26/16	(116)
<b>Total Fair Market Value, Interest Rate Financial Contracts</b>				<b>(197)</b>

(1) Excludes the current stamping fee of 2.25% for each swap.

Interest rate swaps are reset monthly and settled against the BA-CDOR interest rate index.

## 17. INCOME TAX EXPENSE

The provision for income taxes in the consolidated statements of earnings/(loss) and comprehensive income/(loss) reflect an effective tax rate which differs from the expected statutory tax rate. Differences were accounted for as follows:

(\$ thousands)	2014	2013
Earnings/(loss) before tax	<b>8,372</b>	(7,731)
Expected tax rate	<b>25.45%</b>	25.45%
Expected income taxes expense/(recovery)	<b>2,131</b>	(1,967)
Add (deduct) income tax effect of:		
Rate adjustments	<b>(732)</b>	(808)
Permanent differences and other	<b>1,023</b>	944
Total income tax expense/(recovery)	<b>2,422</b>	(1,831)

As at December 31, Zargon's estimated tax pools are as follows:

(\$ thousands)	2014	2013
Canadian development expenses	<b>33,613</b>	56,765
Canadian exploration expenses	<b>58,022</b>	69,046
Capital cost allowance	<b>82,959</b>	79,956
Non-capital losses	<b>101,948</b>	126,791
US tax pools	<b>2,030</b>	1,306
Partnership deferral	–	(28,415)
Other	<b>3,670</b>	4,819
	<b>282,242</b>	310,268

The Company has tax allowances of approximately \$1.70 million (December 31, 2013 - \$1.70 million) which may be applied against future income for Canadian tax purposes. These allowances are not subject to expiry. The benefit of these allowances has not been recognized as they have not been deemed more likely than not to be recovered.

The Company has non-capital losses of approximately \$9.70 million (December 31, 2013 - \$9.70 million) which may be applied against future income for Canadian tax purpose. These non-capital losses are subject to expiry within 20 years. The benefit of these losses has not been recognized as they have not been deemed more likely than not to be recovered.

The movement in deferred tax balances during the years ended December 31, 2014 and 2013 are as follows:

(\$ thousands)	Balance December 31, 2013	Recognized in earnings	Recognized on Balance Sheet	Balance December 31, 2014
Property, plant and equipment and intangible assets	(59,360)	12,442	–	(46,918)
Convertible debentures	(763)	321	–	(442)
Unrealized portion of derivative assets	1,326	(1,276)	–	50
Deferred partnership earnings	(7,327)	7,327	–	–
Non-capital losses	29,794	(6,322)	–	23,472
Asset retirement obligations	35,390	(12,368)	–	23,022
Unrealized portion of derivative liabilities	(5)	(3,050)	–	(3,055)
Share issue costs	705	(250)	–	455
Foreign exchanges	–	985	(985)	–
Other liabilities	219	–	–	219
Net deferred tax asset/(liability)	(21)	(2,191)	(985)	(3,197)

(\$ thousands)	Balance December 31, 2012	Recognized in earnings	Recognized on Balance Sheet	Balance December 31, 2013
Property, plant and equipment and intangible assets	(52,103)	(7,257)	–	(59,360)
Convertible debentures	(1,072)	309	–	(763)
Unrealized portion of derivative assets	67	1,259	–	1,326
Deferred partnership earnings	(4,944)	(2,383)	–	(7,327)
Non-capital losses	26,118	3,676	–	29,794
Asset retirement obligations	29,751	5,639	–	35,390
Unrealized portion of derivative liabilities	(1,221)	1,216	–	(5)
Share issue costs	1,036	(331)	–	705
Foreign exchanges	–	754	(754)	–
Other liabilities	458	(239)	–	219
Net deferred tax asset/(liability)	(1,910)	2,643	(754)	(21)

## 18. PERSONNEL EXPENSES

The Company provides salaries and benefits to its officers as well as director fees to its directors. Directors and officers also participate in the Company's share-based payment compensation programs. Key Management Personnel Compensation is comprised of the following:

Directors and Officers:

(\$ thousands)	2014	2013
Short term employee benefits	4,474	4,018
Share-based payments <sup>(1)</sup>	1,153	1,114
	<b>5,627</b>	<b>5,132</b>

*(1) Represents the amortization of share-based payment compensation granted to directors and officers as recorded in the consolidated financial statements and discussed further in Note 14.*

## 19. EARNINGS/(LOSS) PER SHARE

Basic and diluted net earnings/(loss) per share have been calculated as follows:

(thousands)	2014	2013
Net earnings/(loss) for diluted net loss per share calculation	<b>\$5,950</b>	\$(5,900)
Weighted average number of common shares – basic	<b>30,139</b>	30,015
Dilutive impact of share right incentive plans and share award plan	<b>538</b>	–
Weighted average number of common shares – diluted	<b>30,677</b>	30,015

The average market value of the Company's shares for purposes of calculating the dilutive effect of share options was based on quoted market prices for the period that the options were outstanding. Basic per share amounts are calculated using the weighted average number of shares outstanding during the period. Diluted per share amounts are calculated using the treasury stock method to determine the dilutive effect of share-based compensation. Due to the fact that at the time of exercise, the shareholder has the option of exercising at the original grant price or a modified price as calculated under the New Plan, the prices used in the dilution calculation are the lower prices calculated under the New Plan.

The convertible debentures could potentially dilute basic earnings per share, but were not included in the calculation of diluted earnings per share because they are antidilutive for the periods ended December 31, 2014 and 2013.

## 20. CHANGE IN NON-CASH FLOW INFORMATION

The net change in working capital is comprised of:

(\$ thousands)	2014	2013
Source/(use) of cash:		
Trade and other receivables	2,847	2,573
Deposits and prepaid expenses	(229)	718
Investment in marketable securities	(742)	–
Trade and other payables	(7,479)	(3,327)
Cash dividends payable	6	149
Provisions	(14)	(482)
Foreign exchange and other	110	(392)
	<b>(5,501)</b>	<b>(761)</b>
Related to operating activities	<b>(277)</b>	<b>(1,482)</b>
Relating to investing activities	<b>(5,229)</b>	<b>572</b>
Related to financing activities	<b>5</b>	<b>149</b>
	<b>(5,501)</b>	<b>(761)</b>

## 21. SUPPLEMENTAL CASH FLOW INFORMATION

(\$ thousands)	2014	2013
Cash interest paid	6,080	5,818
Cash taxes paid	361	668

## 22. SIGNIFICANT SUBSIDIARIES

The Company has the following significant wholly owned, directly or indirectly, subsidiaries which are incorporated in Canada as at December 31, 2014:

Subsidiary Name	The Company's effective interest (%)
Zargon Energy Ltd.	100
Zargon Oil & Gas Partnership	100
Zargon U.S. Holdings Ltd.	100

Additionally, the Company has the following significant wholly owned, directly or indirectly, subsidiaries incorporated in the United States:

Subsidiary Name	The Company's effective interest (%)
Zargon Acquisition Inc.	100
Zargon Oil (ND) Inc.	100

### 23. RELATED PARTY TRANSACTIONS

Zargon paid \$0.07 million (2013 – \$0.05 million) for legal services to a law firm of which a Board member is a partner. These payments were in the normal course of operations, were made on commercial terms and, therefore, were recorded at their fair value. As at December 31, 2014, there was \$0.11 million (2013 - \$0.11 million) in payables to a law firm of which a Board member is a partner. There were no purchases, loans or accounts payable with key management personnel.

For Key Management Personnel Compensation, refer to Note 18.

### 24. SEGMENTED INFORMATION

Zargon's entire operating activities are related to exploration, development and production of oil and natural gas in the geographic regions of Canada and the US.

(\$ thousands)	2014		
	Canada	United States	Combined
Petroleum and natural gas sales	133,283	12,605	145,888
Segment profit/(loss)	24,382	(4,806)	19,576
Earnings/(loss) before income taxes	13,473	(5,101)	8,372
Impairment loss	(12,973)	(7,791)	(20,764)
Property, plant and equipment, net	301,540	35,905	337,445
Intangible exploration and evaluation assets and goodwill	10,163	1,217	11,380
Total assets	344,743	37,963	382,706
Net capital expenditures	19,918	6,357	26,275

(\$ thousands)	2013		
	Canada	United States	Combined
Petroleum and natural gas sales	145,427	13,221	158,648
Segment profit/(loss)	(2,376)	4,450	2,074
Earnings/(loss) before income taxes	(11,914)	4,183	(7,731)
Impairment loss	(4,393)	–	(4,393)
Property, plant and equipment, net	371,069	37,650	408,719
Intangible exploration and evaluation assets and goodwill	15,030	1,270	16,300
Total assets	408,682	44,295	452,977
Net capital expenditures	38,294	3,448	41,742

Zargon derives over 91 percent of its revenue from five significant oil and natural gas purchasers.

## 25. COMMITMENTS AND CONTINGENCIES

In the normal course of operations, Zargon executes agreements that provide for indemnification and guarantees to counterparties in transactions such as the sale of assets and operating leases.

These indemnifications and guarantees may require compensation to counterparties for costs and losses incurred as a result of various events, including breaches of representations and warranties, loss of or damages to property, environmental liabilities or as a result of litigation that may be suffered by counterparties.

Certain indemnifications can extend for an unlimited period and generally do not provide for any limit on the maximum potential amount. The nature of substantially all of the indemnifications prevents the Company from making a reasonable estimate of the maximum potential amount that might be required to pay counterparties as the agreements do not specify a maximum amount, and the amounts depend on the outcome of future contingent events, the nature and likelihood of which cannot be determined at this time.

The Company indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their services to the Company to the extent permitted by law. The Company has acquired and maintains liability insurance for its directors and officers. The Company is party to various legal claims associated with the ordinary conduct of business. The Company does not anticipate that these claims will have a material impact on its financial position.

The Company is committed to future minimum payments for natural gas transportation sales commitments, Alkaline Surfactant Polymer purchase commitments and operating leases for office space and office equipment. Payments required under these commitments are as follows:

(thousands)	December 31, 2014
Less than one year	1,060
Between one and five years	429
	<b>1,489</b>

Zargon is subject to normal course income tax audits by Canadian and US taxation authorities. During the fourth quarter of 2010, the Canada Revenue Agency commenced a flow-through share audit of a predecessor company from a prior corporate acquisition. During the first quarter of 2011, Zargon recorded a \$1.27 million provision which was comprised of a \$0.92 million charge to current income tax expense and \$0.35 million charge to interest expense for the related Part XII.6 tax, with respect to this ongoing flow-through share audit. The interest expense related to the Part XII.6 tax has been paid to the Canada Revenue Agency and the remaining provision is currently \$0.39 million (see Note 9).

## CORPORATE INFORMATION

### BOARD OF DIRECTORS

Craig H. Hansen  
Calgary, Alberta

K. James Harrison <sup>(2)</sup>  
Chairman of the Board  
Oakville, Ontario

Kyle D. Kitagawa <sup>(1)</sup>  
Calgary, Alberta

Geoffrey C. Merritt <sup>(1)</sup>  
Calgary, Alberta

Jim Peplinski <sup>(1)(2)</sup>  
Calgary, Alberta

Grant A. Zawalsky <sup>(2)</sup>  
Calgary, Alberta

### OFFICERS

Craig H. Hansen  
President and Chief Executive Officer  
and Interim Chief Financial Officer

Leslie E. Burden  
Vice President, Land

Randolph J. Doetzel  
Vice President, Operations

Christopher M. Hustad  
Vice President, Alberta Plains South

Pete H.S. Janjua  
Vice President, Williston Basin

Brian G. Kergan  
Vice President, Corporate Development

Robert T. Moriyama  
Vice President, Enhanced Recovery

(1) Audit and Reserves Committee

(2) Governance and Compensation Committee

### STOCK EXCHANGE LISTING

#### Toronto Stock Exchange

Common Shares  
Trading Symbol: ZAR

Convertible Debentures  
Trading Symbol: ZAR.DB

### TRANSFER AGENT

Valiant Trust Company  
310, 606 - 4th Street S.W.  
Calgary, Alberta T2P 1T1

### BANKERS

The Toronto Dominion Bank  
1100, 421 - 7th Avenue S.W.  
Calgary, AB T2P 4K9

Canadian Imperial Bank of Commerce  
9th Floor, Bankers Hall East  
855 - 2nd Street S.W.  
Calgary, Alberta T2P 2P2

The Bank of Nova Scotia  
2000, 700 - 2nd Street S.W.  
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