



**2018 ANNUAL FINANCIAL REPORT**

## ABBREVIATIONS

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
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 2018 financial results and should be read in conjunction with the audited consolidated financial statements and related notes for the years ended December 31, 2018 and 2017. The 2018 and 2017 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 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 the convertible debenture of \$41.94 million (\$57.50 million prior to March 31, 2017) and the debt face value of \$4.97 million (December 31, 2017 – nil) and any working capital 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 per boe, 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 14, 2019, and contains forward-looking statements including:

- our expectations for our use of funds from our US term debt and the terms of the loan referred to under the headings “2018 Highlights”, “Detailed Financial Analysis” and “Liquidity and Capital Resources and Going Concern”;
- our expectations for the WTI-WCS differentials referred to under the headings “Detailed Financial Analysis” and “Outlook”;
- our strategic alternatives process referred to under the heading “Outlook”;
- our expectations for the Company’s ability to continue as a going concern referred to under the heading “Liquidity and Capital Resources and Going Concern”; and
- our expected sources of funds for capital expenditures referred to under the heading “Liquidity and Capital Resources and Going Concern”.

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 14, 2019.

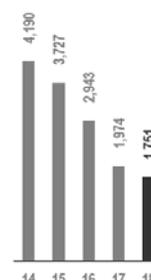
## ABOUT ZARGON OIL & GAS LTD.

Zargon Oil & Gas Ltd. (“the Company” or “Zargon”) is a publicly traded 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”).

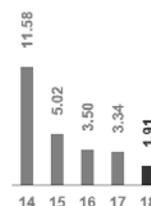
### 2018 HIGHLIGHTS

- For calendar 2018, funds flow was a negative \$0.54 million (a negative \$0.02 per basic share) compared to funds flow from operating activities of \$5.99 million (\$0.20 per basic share) recorded in the prior year.
- Oil and liquids production averaged 1,751 barrels of oil and liquids per day in 2018, an 11 percent decrease from the preceding year. Natural gas production averaged 1.91 million cubic feet per day in 2018, a 43 percent decrease from 2017. The reduction in production volumes was primarily due to the suspension of discretionary oil exploitation capital programs, the deferral of routine maintenance operations due to cash constraints and the shut-in of uneconomic natural gas properties. Total 2018 production averaged 2,069 barrels of oil equivalent per day, an 18 percent decrease from the prior year.
- Zargon’s 2018 net loss was \$35.37 million, which compares to a net loss of \$9.31 million in 2017 and a net loss of \$20.18 million in 2016. The net earnings/loss track the funds flow from operating activities for the respective periods modified by non-cash charges, which in 2018 were primarily related to an unrealized gain on derivatives, depletion and depreciation expense, accretion expense, and impairment losses. On a per diluted share basis, the 2018 net loss was \$1.15 compared to a net loss of \$0.30 in 2017 and a net loss of \$0.66 in 2016.
- 2018 net capital expenditures for the year totalled \$4.30 million. These expenditures consisted of \$4.67 million of exploitation, development and facility expenditures, \$0.40 million of net property dispositions, and \$0.03 million of administrative assets. The \$4.67 million of exploitation, development and facility programs include \$2.17 million of chemical costs for the Alkaline Surfactant Polymer (“ASP”) Little Bow project. During the year, Zargon drilled nil net wells.
- 2018 and reclamation costs totaled \$1.94 million, a \$0.17 million decrease from the \$2.11 million recorded in the prior year.
- On November 2, 2018, Zargon entered into a financing agreement for \$3.50 million (USD) term debt. The loan is secured by all U.S. assets of Zargon. The loan bears interest at 11% and principal repayments commence on July 1, 2019 at \$0.05 million (USD) per month and on October 1, 2019 principal repayments will be \$0.08 million (USD) per month until maturity at April 1, 2020 when the balance of the principal plus an original issue discount of \$0.15 million (USD) is payable.
- On January 11, 2019, subsequent to year end, Zargon announced the completion of a transaction to settle its \$41.94 million principal amount of outstanding 8% Convertible Debentures due December 31, 2019 in exchange for common shares of Zargon. Immediately before the transaction, 30,932,912 common shares were issued and outstanding. Following the completion of the transaction, 459,811,236 common shares were issued and outstanding. Following closing, the Company has reduced its overall debt by \$41.94 million and its annual interest burden by \$3.36 million, resulting in a simplified capital structure with only \$3.50 million (USD) of term debt outstanding.

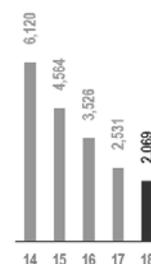
**Oil and Liquids Production**  
(bbl/d)



**Natural Gas Production**  
(mmcf/d)



**Production**  
(boe/d)



## Financial Highlight

(\$ millions, except for per share amounts)	2018	2017	2016
Petroleum and natural gas sales	<b>35.49</b>	38.68	44.72
Funds flow from operating activities	<b>(0.54)</b>	5.99	3.58
Per share – basic	<b>(0.02)</b>	0.20	0.12
Cash flows from operating activities	<b>1.22</b>	2.48	4.66
Per share – basic	<b>0.04</b>	0.08	0.15
Net loss	<b>(35.37)</b>	(9.31)	(20.18)
Per share – diluted	<b>(1.15)</b>	(0.30)	(0.66)
Total assets	<b>108.41</b>	140.55	169.39
Net capital expenditures/(dispositions) <sup>(1)</sup>	<b>4.30</b>	8.86	(85.13)
Debt <sup>(2)</sup>	<b>4.97</b>	–	–
Convertible debentures <sup>(3)</sup>	<b>41.94</b>	41.94	57.50

(1) Amounts include capital expenditures for property acquisitions acquired for cash consideration.

(2) Amount is the full future face value of the \$3.5 million (USD) term debt plus an original issue discount of \$0.15 million (USD) in Canadian dollars

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

## Production Highlights

	2018	2017	2016
Oil and liquids production (bbl/d)	<b>1,751</b>	1,974	2,943
Natural gas production (mmcf/d)	<b>1.91</b>	3.34	3.50
Production (boe/d)	<b>2,069</b>	2,531	3,526
Oil weighting (%)	<b>85</b>	78	83

## DETAILED FINANCIAL ANALYSIS

### Petroleum and Natural Gas Sales

(\$ millions)	2018	2017	Percent Change
Petroleum sales	<b>34.49</b>	36.25	(5)
Natural gas sales	<b>1.00</b>	2.43	(59)
Petroleum and natural gas sales	<b>35.49</b>	38.68	(8)

Petroleum and natural gas sales, exclusive of the impact of financial risk management contracts, were \$35.49 million in 2018 compared to \$38.68 million in 2017. For 2018, production revenue from oil and liquids was 97 percent of revenue (94 percent in 2017) with three percent coming from the sale of natural gas (six percent in 2017). Average production volumes in 2018 decreased to 2,069 barrels of oil per day compared to the prior year's 2,531 barrels of oil equivalent per day. Of the 2,069 barrels of oil equivalent per day of production volumes in 2018, oil and liquids were 85 percent (15 percent natural gas), as compared to 78 percent in 2017.

Oil and liquids production decreased 11 percent from 2017 levels and natural gas production in 2018 decreased 43 percent. Oil and liquids production declines were due to our suspension of discretionary oil exploitation capital programs and the deferral of routine maintenance operations due to cash constraints. Natural gas production declines continued as a result of the shut-in of uneconomic gas production resulting from low field prices and naturally occurring production declines. The average field price of oil and liquids received by Zargon increased to \$53.96 per barrel in 2018, up seven percent from \$50.30 per

**Petroleum and Natural Gas Sales**  
(\$ millions)



barrel in 2017. The average Zargon realized field price of natural gas was \$1.43 per thousand cubic feet in 2018, a 28 percent decrease from \$1.99 per thousand cubic feet realized in 2017.

### Production by Core Area

	2018			2017		
	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	434	0.67	546	528	1.65	803
Alberta Plains South	913	1.24	1,119	1,067	1.69	1,349
Williston Basin	404	–	404	379	–	379
	<b>1,751</b>	<b>1.91</b>	<b>2,069</b>	1,974	3.34	2,531

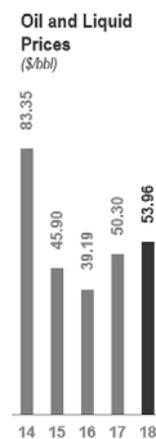
### Pricing

Average for the period	2018	2017	2016
<b>Natural Gas:</b>			
NYMEX average daily spot price (\$US/mmbtu)	3.12	2.96	2.48
AECO average daily spot price (\$Cdn/mmbtu)	1.50	2.16	2.16
Zargon realized field price (\$Cdn/mcf)	1.43	1.99	1.95
Zargon realized natural gas field price differential (\$Cdn/mcf)	0.07	0.17	0.21
<b>Crude Oil:</b>			
WTI (\$US/bbl)	64.77	50.95	43.32
Edmonton par price (\$Cdn/bbl)	69.37	62.79	53.22
Western Canadian Select price (\$Cdn/bbl)	49.68	50.54	38.87
Zargon realized field price before the impact of financial risk management contracts (\$Cdn/bbl)	53.96	50.30	39.19
Zargon realized field price after the impact of financial risk management contracts (\$Cdn/bbl)	50.20	49.78	41.47
Zargon realized oil field price differential to WCS <sup>(1)</sup>	4.28	(0.24)	0.32
WTI (\$Cdn/bbl) to WCS (\$Cdn/bbl) differential	34.21	15.57	18.36

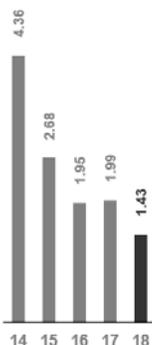
(1) Calculated as Zargon's realized field price before the impact of financial risk management contracts (\$Cdn/bbl) as compared to the Western Canadian Select price (\$Cdn/bbl).

### 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 2018, Zargon's average oil and liquids field price, exclusive of the impact of financial risk management contracts, increased seven percent to \$53.96 per barrel from \$50.30 per barrel in 2017 and was 38 percent higher than the \$39.19 per barrel received in 2016. Our Alberta field price ties closely with the Western Canadian Select ("WCS") price, and despite a 27 percent year over year increase in WTI prices, our corresponding Alberta field price only increased three percent. The 2018 WCS price differential of \$34.21 per barrel increased substantially compared to the 2017 differential of \$15.57 per barrel and the 2016 differential of \$18.36 per barrel. The WCS differential increased to record levels in November and December 2018 due to an increased supply of crude oil from western Canada, refinery turnarounds in the US, and a lack of pipeline capacity in western Canada. Looking forward, the temporary mandated production curtailments in the province of Alberta have contributed to an improved outlook for the WCS differentials in the first quarter of 2019.



**Natural Gas  
Prices  
(\$/mcf)**



**Natural Gas Pricing**

The average field natural gas price for 2018 decreased to \$1.43 per thousand cubic feet, which is 28 percent lower than the 2017 average of \$1.99 per thousand cubic feet. 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 2018 field price differential for Zargon's natural gas was a discount of \$0.07 per thousand cubic feet, compared to discounts of \$0.17 and \$0.21 per thousand cubic feet (exclusive of the impact of physical and financial risk management contracts) in 2017 and 2016, respectively.

**Royalties**

(\$ millions)	2018	2017	Percent Change
Royalties	5.11	4.44	15
Percentage of revenue	14.4%	11.5%	

Royalties include payments made to the Crown, freehold owners and third parties. Reported royalties also include the cost of North Dakota state oil production/extraction taxes. During 2018, total royalties were \$5.11 million, an increase of 15 percent from \$4.44 million in 2017 due to an increase in crude oil prices and a one-time adjustment of \$0.14 million. The variations in royalty rates generally track changes in production volumes and prices. As a percentage of gross sales, royalties were 14.4 percent in 2018 compared to 11.5 percent in 2017 and 11.6 percent in 2016. On a commodity basis, natural gas royalties averaged nil percent in 2018, a decrease from the previous year's average of 6.0 percent. Oil royalties averaged 14.8 percent, an increase from the prior year rate of 11.8 percent, due to a seven percent increase in the oil and liquids production weighting percentage.

During 2018, 35 percent (2017 – 30 percent) of the total royalties were paid to provincial and state governments, with the remainder paid to freehold owners and other third parties. North Dakota state oil production/extraction taxes were \$0.64 million in 2018 and compared to \$0.50 million in 2017.

**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 each commodity up to a 30 month period. Zargon may also enter into interest rate swaps.

For 2018, the total realized derivative loss was \$2.41 million; compared to a loss of \$0.38 million in 2017 and a gain of \$2.25 million in 2016. For 2018, there was a \$2.41 million loss (equivalent to a decrease of \$3.19 per barrel of oil equivalent) from oil financial risk management transactions. Oil swaps are settled against the NYMEX WTI pricing index.

For accounting purposes, an unrealized gain or loss from forward sale commodity contracts is recorded based on the fair value ("mark-to-market") of the contracts at the period end. 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 sheets.

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 2018 net unrealized derivative gain totalled \$1.15 million, which compares to a \$0.80 million net unrealized derivative gain in 2017 (2016 – \$4.07 million loss). Specifically, the 2018 net unrealized derivative gain resulted from financial oil contracts. 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.

There are currently no derivative contracts outstanding.

### Operating Expenses and Transportation Expenses

(\$ millions)	2018	2017	Percent Change
Operating expenses	20.39	19.68	4
Transportation expenses	0.43	0.45	(4)
Total	20.82	20.13	3
Total (\$/boe)	27.57	21.79	27

Zargon’s operating expenses increased by four percent to \$20.39 million in 2018 from \$19.68 million in 2017 due to higher electricity costs offset by lower workover expenditures. Transportation expenses decreased four percent to \$0.43 million from \$0.45 million in 2017. On a per unit of production basis, operating and transportation expenses increased 27 percent to \$27.57 per barrel of oil equivalent from \$21.79 in 2017 primarily due decreased oil and gas production volumes.

Natural gas operating expenses in 2018 increased 61 percent to \$4.56 per thousand cubic feet from \$2.83 per thousand cubic feet in 2017. Oil operating and transportation expenses increased in 2018 to \$27.60 per barrel, an increase of 19 percent from \$23.15 per barrel in 2017.

### Operating Netbacks

	2018		2017	
	Oil and Liquids (\$/bbl)	Natural Gas (\$/mcf)	Oil and Liquids (\$/bbl)	Natural Gas (\$/mcf)
Sales	53.96	1.43	50.30	1.99
Royalties	(8.00)	–	(5.94)	(0.12)
Realized (loss)/gain on derivatives	(3.76)	–	(0.52)	–
Operating expenses	(26.92)	(4.56)	(22.52)	(2.83)
Transportation expenses	(0.68)	–	(0.63)	–
Operating netbacks	14.60	(3.13)	20.69	(0.96)

The average oil and liquids price received, after realized derivative gains/losses, in 2018 of \$50.20 per barrel was relatively unchanged from the \$49.78 per barrel received in 2017. The average natural gas price received in 2018 of \$1.43 per thousand cubic feet was 28 percent lower than the \$1.99 per thousand cubic feet received in 2017. Oil and liquids netbacks at \$14.60 per barrel were down from the 2017 netbacks of \$20.69 per barrel due to an increase in royalties, realized loss on derivatives and operating expenses. Natural gas netbacks increased to a negative \$3.13 per thousand cubic feet from a negative \$0.96 per thousand cubic feet in 2017 due to an increase in operating expenses. On a barrel of oil equivalent basis, overall 2018 operating netbacks decreased to \$9.47 from \$14.86 in 2017.

### General and Administrative Expenses

(\$ millions, except as noted)	2018	2017	2016
Gross general and administrative expenses	4.86	5.53	9.30
Overhead recoveries	(1.24)	(1.37)	(1.68)
Net general and administrative expenses	3.62	4.16	7.62
Net expense after recoveries (\$/boe)	4.80	4.50	5.91
Number of office employees at year end	12	13	14

Gross general and administrative expenses (“G&A”) decreased 12 percent in 2018 to \$4.86 million from \$5.53 million in 2017. On a per unit of production basis, net G&A expenses increased seven percent to \$4.80 per barrel of oil equivalent compared to \$4.50 per barrel of oil equivalent in 2017 and decreased from \$5.91 in 2016. G&A expenses decreased in 2018 from the prior year primarily due to a continued focus on G&A cost containment initiatives, offset by one-time employment related costs of \$0.13 million (2017 – \$0.18 million) or \$0.17 per barrel of oil equivalent. Excluding the one-time employment related costs, the 2018 G&A expenses averaged \$4.63 per barrel of oil equivalent.

#### **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 and the strategic alternatives review. 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, 2018, transaction costs were \$0.28 million, or \$0.37 per barrel of oil equivalent, and were comprised of legal and consulting fees associated with the strategic alternatives review. For the year ended December 31, 2017, transaction costs were \$0.24 million or \$0.26 per barrel of oil equivalent and were comprised of legal and consulting fees associated with the strategic alternatives review.

#### **Interest and Financing Charges on Debt**

On November 2, 2018, Zargon entered into a financing agreement for \$3.50 million (USD) term debt. The loan is secured by all U.S. assets of Zargon. The loan bears interest at 11% and principal repayments commence on July 1, 2019 at \$50,000 (USD) per month and on October 1, 2019 principal repayments will be \$75,000 (USD) per month until maturity at April 1, 2020 when the balance of the principal plus an original issue discount of \$145,833 (USD) is payable.

Interest and financing charges were \$0.35 million or \$0.46 per barrel of oil equivalent in 2018 compare to nil in 2017 and \$1.81 million in 2016. The fluctuations in interest and financing charges/income resulted from the 2018 financing agreement for term debt, and in the fourth quarter of 2016 the credit facility was terminated, which resulted in a nil balance for 2017.

#### **Interest on Convertible Debentures**

The interest on convertible debentures charges for 2018 were \$3.35 million or \$4.44 per barrel of oil equivalent.

On January 11, 2019, subsequent to year end, Zargon announced the completion of a transaction to settle its \$41.94 million Convertible Debentures. Following the closing, the Company has reduced its overall debt by \$41.94 million and its associated annual interest burden. For more information on Zargon’s convertible debentures and this transaction, see the “Convertible Debentures” section of this report.

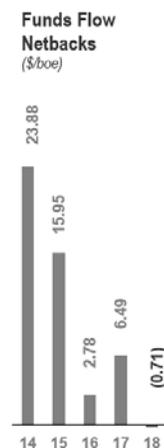
#### **Current Tax**

The current tax expense for 2018 was \$0.09 million compared to a recovery of \$0.03 million in 2017. The 2018 current tax expense was related to the US operations, whereas Zargon reversed a prior period provision in 2017 and 2016.

Tax pools as at December 31, 2018 were approximately \$204 million, up slightly from the \$197 million of tax pools available to Zargon at the end of 2017. 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.

## Corporate Netbacks

(\$/boe)	2018	2017	2016
Petroleum and natural gas sales	<b>46.99</b>	41.86	34.65
Royalties	<b>(6.76)</b>	(4.80)	(4.02)
Realized derivative gain/(loss)	<b>(3.19)</b>	(0.41)	1.75
Operating expenses	<b>(27.00)</b>	(21.30)	(18.37)
Transportation expenses	<b>(0.57)</b>	(0.49)	(0.46)
Operating netbacks	<b>9.47</b>	14.86	13.55
General and administrative expenses	<b>(4.80)</b>	(4.50)	(5.91)
Transaction costs	<b>(0.37)</b>	(0.26)	(0.89)
Interest and financing charges	<b>(0.46)</b>	0.01	(1.41)
Interest on convertible debentures	<b>(4.44)</b>	(3.65)	(2.67)
Current tax (expense)/recovery	<b>(0.11)</b>	0.03	0.11
Funds flow netbacks	<b>(0.71)</b>	6.49	2.78



Operating netbacks in 2018 decreased 36 percent compared to 2017. On a barrel of oil equivalent basis, revenue of \$46.99 in 2018 was 12 percent higher than 2017, while operating netbacks decreased to \$9.47 and funds flow netbacks decreased to a negative \$0.71 per barrel of oil equivalent.

## Depletion and Depreciation

In 2018, Zargon's depletion and depreciation expense decreased 15 percent to \$11.41 million, compared to \$13.47 million in 2017. The lower charges are due to lower production volumes and decreased future capital expenditures in the year-end reserve evaluation offset by a decrease in reserves. 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 one barrel of oil. The 2018 depletion calculation includes \$22.12 million of future capital expenditures (compared to \$61.15 million in 2017) to develop the Company's reserves

Zargon's depletion and depreciation, on a barrel of oil equivalent basis, increased four percent in 2018 to \$15.11 from \$14.58 in 2017 and decreased three percent from the 2016 rate of \$15.54.

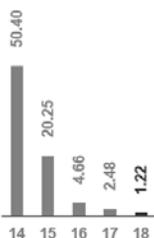
## Accretion of Asset Retirement Obligations, Debt and Convertible Debentures

For the year ended December 31, 2018, the non-cash accretion expense for asset retirement obligations was \$1.45 million compared to \$1.48 million in 2017 and \$1.73 million in 2016. Compared to prior year, accretion expense was relatively unchanged. The significant assumptions used in this calculation are a risk-free rate of 2.25 percent, an inflation rate of two percent and payments to settle the retirement obligations occurring over the next 50 years, with the majority of the costs being incurred after 2032. At the end of the second quarter of 2016, the discount factor of 2.50 percent was decreased to 2.25 percent based on the Government of Canada long term bond rate. The estimated net present value of the total asset retirement obligation was \$63.41 million as at December 31, 2018, based on a total future liability of \$67.37 million.

Zargon's \$3.50 million (USD) term debt is accreted over its term, up to the total principal balance plus an original issue discount of \$0.15 million (USD), for a total face value of \$3.65 million (USD) or \$4.97 million Canadian dollars. Accretion on the term debt for 2018 was \$0.03 million, which compares to nil for 2017 and 2016.



**Cash Flows from Operating Activities**  
(\$ millions)



The debt portion of Zargon's convertible debenture is also accreted over its term, up to the total maturity value of \$41.94 million. Accretion on the convertible debenture for 2018 was \$0.47 million compared to \$0.60 million in 2017. On January 11, 2019, subsequent to year end, Zargon announced the completion of a transaction to settle its \$41.94 million Convertible Debentures. For more information on Zargon's convertible debentures and this transaction, see the "Convertible Debentures" section of this report.

### Share-Based Compensation

Share-based compensation was \$0.14 million in 2018, \$0.23 million lower than the \$0.37 million expense in 2017 due to the expiration of share awards. Zargon will continue to use fair value methodologies for future share award / stock option grants. These non-cash expenses will be recurring charges in future years if Zargon continues to grant employees and directors share awards / stock options.

On March 24, 2017, Zargon granted an aggregate of 1.34 million stock options to our directors, officers and employees at an exercise price of \$0.72 per share under the Stock Option Plan. Of these, 0.32 million options were granted to our non-management directors, 0.54 million options were granted to our officers and the balance of 0.48 million stock options were granted to employees. One-third of the options on December 31, 2017, one-third vested on December 31, 2018 and the balance will vest on December 31, 2019. Zargon uses a fair value methodology to value the stock options. The assumptions made for the stock options include a volatility of 64 percent, a risk free rate of one percent and a forfeiture rate of nil. On May 30, 2017, the 2017 stock option plan was approved by a majority of the aggregate votes casted by shareholders at the 2017 Annual and Special General Meeting. At December 31, 2018, Zargon had 1.17 million stock options outstanding.

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 awards shall not, at any time, exceed 10 percent of the aggregate number of the total outstanding shares. At December 31, 2018, Zargon had 0.27 million of share awards outstanding. The Share Award Plan was not renewed in 2017, and no further grants were awarded subsequent to May 2016.

### Unrealized Foreign Exchange

An unrealized foreign exchange gain of \$0.12 million in 2018 compared to a loss of \$0.07 million in 2017. 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).

**Exploration and Evaluation Expenses** Exploration and evaluation expenses for 2018 were nil compared to \$0.39 million expenses incurred in 2017. Exploration and evaluation expenses were the result of land expiries.

### Impairment Loss on Property, Plant and Equipment

As at December 31, 2018, the Company tested its cash generating units ("CGUs"), as defined under IFRS, for impairment. Low crude oil and natural gas prices resulted in impairment in the Alberta Plains South CGU. The exploration and evaluation ("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 of disposal. The estimate of fair value less costs of disposal was determined using an after-tax discount rate of 10 percent and forecasted cash flows. The prices used to estimate the fair value less costs of disposal are those used by McDaniel and Associates Consultants Ltd., our independent reserve engineers.

Based on the assessment on December 31, 2018, the carrying amount of the Alberta Plains South CGU was determined to be \$21.16 million higher than its recoverable amount, and an impairment loss was recognized. The carrying amounts after impairment as at December 31, 2018 were \$23.10 million, \$56.03 million, and \$21.52 million for the Alberta Plains North, Alberta Plains South, and Williston Basin USA CGUs, respectively. As at December 31, 2017, the Company determined there was \$1.80 million in impairment on property, plant and equipment.

#### **Impairment Loss on Exploration and Evaluation**

As at December 31, 2018, the Company tested its exploration and evaluation (“E&E”) assets for impairment. The Company uses the cost valuation model instead of the revaluation model to value its assets and has assessed its undeveloped land value as at December 31, 2018.

Based on the assessment on December 31, 2018, the carrying amounts of the three CGUs were tested and determined to be \$1.82 million higher than their fair value of nil, and an impairment loss was recognized and the balance was written-off. Zargon did not drill any wells during 2018 and has not budgeted any conventional drilling in 2019. The impairment relates to the Alberta Plains North, Alberta Plains South, and Williston Basin USA CGUs. As at December 31, 2017, the Company determined there was \$0.24 million in impairment on E&E assets.

#### **Impairment Loss on Marketable Securities**

As at March 31, 2017 and June 30, 2017, the Company tested its marketable securities for impairment. Decreased values in market capitalization resulted in impairment of marketable securities. The fair value of the marketable securities was estimated at March 31, 2017 and June 30, 2017 with the book value estimated at the time they were acquired or previously written-down.

Based on the assessment on March 31, 2017, the carrying amounts of the marketable securities were determined to be \$0.14 million higher than their recoverable amount of \$0.05 million, and an impairment loss was recognized. Based on the assessment on June 30, 2017, the carrying amount of the marketable securities were determined to be \$0.05 million higher than their recoverable amount of nil, and an impairment loss was recognized and as such, the remaining balance was written-off.

#### **Deferred Tax**

The deferred tax recovery for 2018 was \$0.37 million compared to a deferred tax recovery of \$2.04 million in 2017 and a deferred tax expense of \$17.50 million in 2016. The deferred tax calculation only includes our US operations, as the deferred tax assets in Canada have not been recognized since the second quarter of 2016. The 2018 deferred tax recovery is lower than the prior year, as the 2017 tax provision incorporated the permanent reduction in the US corporate tax rate which resulted in a significant tax recovery in 2017. For more information, refer to Note 17 in the audited consolidated financial statements for the year ended December 31, 2018.

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

2018 funds flow decreased due to a decrease in revenue and an increase in royalties, realized loss on derivatives and interest expense, and was partially offset by a decrease in G&A expenses resulted in a 109 percent decrease in funds flow from operating activities of a negative \$0.54 million, compared to \$5.99 million in 2017 and \$3.58 million in 2016. The corresponding funds flow per basic share was a negative \$0.02 in 2018, a 110 percent decrease from \$0.20 in 2017 and a 117 percent decrease from \$0.12 in 2016. The basic per share statistics reflect a minimal increase in the weighted average outstanding shares to 30.88 million in 2018 from 30.73 million in 2017. The 2017 weighted average outstanding shares reflected a minimal increase than the 2016 amount of 30.50 million.

Details of the change in funds from operating activities during 2018 are as follows:

(\$ millions)	2018			
	Q4	Q3	Q2	Q1
<b>Funds flow from operating activities, prior quarter</b>	<b>1.93</b>	0.58	(0.30)	1.59
<b>Variances from prior quarter:</b>				
<b>Revenue and royalties:</b>				
Volume	<b>(0.87)</b>	(0.73)	(1.14)	(0.17)
Price	<b>(4.54)</b>	0.07	2.27	(0.42)
Royalties	<b>0.82</b>	0.03	(0.28)	(0.09)
Realized Derivatives	–	1.56	(0.71)	(0.24)
<b>Expenses:</b>				
Operating and transportation	<b>0.20</b>	0.37	0.76	(0.98)
General and administrative	<b>(0.07)</b>	0.15	–	0.03
Transaction costs	–	0.01	(0.01)	(0.03)
Interest and financing	<b>(0.34)</b>	–	(0.01)	0.01
Current taxes	<b>0.13</b>	(0.11)	–	–
<b>Funds flow from operating activities for the quarter</b>	<b>(2.74)</b>	1.93	0.58	(0.30)

#### Net Loss

Zargon's 2018 net loss was \$35.37 million, which compares to net loss of \$9.31 million in 2017 and a \$20.18 million net loss in 2016. The net earnings/loss track the funds flow from operating activities for the respective periods modified by non-cash charges, which in 2018 were primarily related to impairment losses, a realized loss on derivatives and decreased revenues. On a per diluted share basis, the 2018 net loss was \$1.15 compared to net loss of \$0.30 in 2017 and a net loss of \$0.66 in 2016.

#### Capital Expenditures

Total net capital expenditures in 2018 of \$4.30 million compares to \$8.86 million in 2017, Zargon's field capital expenditure program decreased 46 percent in 2018 to \$4.67 million from \$8.58 million in 2017. Field capital expenditures include ASP project expenditures of \$2.62 million in 2018 compared to \$2.73 million in 2017. In 2018, ASP project expenditures are broken down into \$0.45 million of project and exploitation costs and \$2.17 million of chemical costs compared to \$0.87 million of project and exploitation costs and \$1.86 million of chemical costs in 2017. Zargon drilled nil wells in 2018 and 2017. Of the total 2018 field capital expenditures (excluding net property dispositions), \$0.48 million were spent on Alberta Plains North, \$3.76 million on Alberta Plains South (including ASP project expenditures) and \$0.43 million on Williston Basin properties. Additionally, \$0.40 million of net property dispositions and \$0.03 million of administrative asset expenditures were incurred during 2018.

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 a diluted chemical solution into a partially depleted oil reservoir to recover incremental oil reserves.

## Capital Expenditures

(\$ millions)	2018	2017	2016
Undeveloped land	1.02	1.81	1.93
Geological and geophysical (seismic)	0.20	0.28	0.19
Drilling and completion of wells	0.50	1.61	0.16
Well equipment and facilities	0.33	2.15	–
ASP project and exploitation costs	0.45	0.87	0.55
ASP chemical costs	2.17	1.86	4.21
Exploration and development	4.67	8.58	7.04
Property acquisitions	–	0.21	0.07
Property dispositions	(0.40)	–	(92.12)
Net property acquisitions/(dispositions)	(0.40)	0.21	(92.05)
Total net capital expenditures excluding administrative assets	4.27	8.79	(85.01)
Administrative assets	0.03	0.07	(0.12)
Total net capital expenditures	4.30	8.86	(85.13)

## LIQUIDITY AND CAPITAL RESOURCES AND GOING CONCERN

On November 2, 2018, Zargon entered into a financing agreement for \$3.50 million (USD) term debt. The loan is secured by all U.S. assets of Zargon. The loan bears interest at 11% and principal repayments commence on July 1, 2019 at \$50,000 (USD) per month and on October 1, 2019 principal repayments will be \$75,000 (USD) per month until maturity at April 1, 2020 when the balance of the principal plus an original issue discount of \$145,833 (USD) is payable.

At December 31, 2018, the Company's combined debt net of working capital (excluding unrealized derivative assets/liabilities) was \$45.17 million, which compares to \$38.41 million of net debt at the end of December 31, 2017. The increase in net debt was as a result of decreased accounts receivable balances, due to the decreased realized field price received in November and December 2018, and \$4.97 million (CDN) term debt obtained in the fourth quarter of 2018. The \$45.17 million net debt consists of the \$41.94 million (\$57.50 million prior to March 31, 2017) of convertible unsecured subordinate debentures and the face value of the principal amount of the term debt, which includes the original issue discount, of \$4.97 million (CDN) (nil as at December 31, 2017), which is partially offset by net cash balances.

On January 11, 2019, subsequent to year end, Zargon announced the completion of a transaction to settle its \$41.94 million principal amount of outstanding 8% Convertible Debentures due December 31, 2019 in exchange for common shares of Zargon. Following closing, the Company has reduced its overall debt by \$41.94 million and its annual interest burden by \$3.36 million, resulting in a simplified capital structure with only \$3.5 million (USD) of term debt outstanding. As such, at December 31, 2018, the Company's pro forma debt net of working capital is \$2.39 million after removing the face value of the convertible debenture of \$41.94 million and accrued interest of \$0.84 million.

The volatility of oil and natural gas prices, uncertainty or modifications regarding royalties and Canadian income tax rules and global economic/political concerns have, on occasion, restricted the oil and natural gas industry's ability to attract new capital from debt and equity markets.

Zargon's operational results and financial condition, and, therefore, the funds available to be allocated to capital expenditures, are dependent on the prices received for oil and natural gas production.

These financial statements have been prepared in accordance with generally accepted accounting

principles applicable to a going concern, which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business. For the year ended December 31, 2018, the Company has working capital of \$1.75 million (defined as current assets less accounts payable), positive cash flows from operating activities of \$1.22 million and generated a net loss of \$35.37 million. Sustained low commodity prices in recent months have put pressure on the Company's cash flows. Specifically, the WCS differential increased to record levels in November and December 2018 due to an increased supply of crude oil from western Canada, refinery turnarounds in the US, and a lack of pipeline capacity in western Canada which resulted in the deterioration of Company projections on cash flows. As a result, there is material uncertainty related to future events that may cast substantial doubt on the Company's ability to continue as a going concern and therefore, it may be unable to realize its assets and discharge its liabilities in the normal course of business. The continuation of the Company as a going concern is dependent upon the occurrence of all or some of these future events: actual prices exceeding the current estimates in the coming six months, accessing additional capital, or other unforeseen events. In an effort to mitigate these challenges, the Company obtained \$3.50 million (USD) of term debt in November 2018, and furthermore in January 2019 the Company settled its outstanding \$41.94 million convertible debentures, thereby eliminating \$4.20 million of debenture interest payments that were due and payable in 2019. These financial statements do not reflect adjustments that would be necessary if the going concern assumption were not appropriate. If the going concern basis were not appropriate for these financial statements, then adjustments would be necessary in the carrying value of the assets and liabilities, the reported revenues and expenses, and the balance sheet classifications used. These adjustments could be material.

For the year ended December 31, 2018, net capital expenditures totalled \$4.30 million, which was \$3.08 million higher than cash flows from operating activities (after changes in non-cash working capital) of \$1.22 million. For the year ended December 31, 2017, net capital expenditures totalled \$8.86 million, which was \$6.38 million higher than cash flows from operating activities (after changes in non-cash working capital) of \$2.48 million. Zargon relies on access to debt and capital markets to the extent 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 capital expenditures with its cash flows from operating activities; however, it may fund 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.

#### Capital Sources and Uses

(\$ millions)	2018	2017	2016
Funds flow from operating activities	<b>(0.54)</b>	5.99	3.58
Change in debt	<b>4.80</b>	–	(60.24)
Change in cash	<b>(0.96)</b>	–	–
Change in convertible debentures	–	(15.42)	–
Asset retirement costs	<b>(1.94)</b>	(2.11)	(0.08)
Changes in working capital and other	<b>2.94</b>	20.40	(28.39)
<b>Total capital sources</b>	<b>4.30</b>	8.86	(85.13)

#### Funds Flow from Operating Activities

It is anticipated that Zargon's 2019 exploration and development capital budget will be financed through the Company's funds flow from operating activities. Funds flow is partially influenced by production volumes, commodity prices and the US/Canadian dollar exchange rates. Zargon's 2019 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 2019 Funds Flow	
	(\$ millions)	(\$/share)
Change of \$1.00 US/bbl in the price of WCS oil	0.49	–
Change in oil production of 100 bbl/d	0.67	–
Change of \$0.10 US/mcf in the price of NYMEX natural gas	0.05	–
Change of \$0.01 in the \$US/\$Cdn exchange rate	0.27	–

### Debt

On November 2, 2018 the Company entered into a financing agreement for \$3.50 million (US) term debt. These funds will be utilized for low risk oil exploitation capital projects and general corporate purposes. The terms of the loan are:

- The loan is secured by the Zargon's North Dakota assets.
- The loan bears interest at 11%.
- Principal repayments commence July 1, 2019 at \$0.05 million (US) per month until September 1, 2019 and on October 1, 2019 principal repayments will be \$0.08 million (US) per month until maturity at April 1, 2020 when the balance of the principal plus an original issue discount of \$0.15 million (US) is payable.
- The loan may be prepaid at any time, but is subject to make whole prepayment interest penalties calculated on the lesser of the remaining term of the loan or 12 months.
- Additional payments of 8% of incremental revenue earned (after payment of royalties) in excess of a \$63.50 (US) per barrel field price threshold, will also be made to the lender.
- If Zargon's North Dakota monthly production is less than 300 barrels of oil per day but exceeds 240 barrels of oil per day or if the Zargon's North Dakota properties EBITDA in a trailing 12 month period is less than \$1.75 million (US) but exceeds \$1.25 million (US), the Company is required to make an additional monthly principal repayment of \$0.08 million (US).
- If Zargon's North Dakota's monthly production is less than 240 barrels of oil per day or if Zargon's North Dakota properties EBITDA in a trailing 12 month period is less than \$1.25 million US, the lender may demand immediate payment of the loan, accrued interest, and any applicable make whole payment.

### Subsequent Event and Convertible Debentures

On November 21, 2018, Zargon announced the proposed transaction to settle its Convertible Debentures, details are more particularly described in the Company's information circular dated December 1, 2018 (the "Information Circular") which is available on the Company's SEDAR profile at [www.sedar.com](http://www.sedar.com).

On January 10, 2019, Zargon announced that 82.64% of Debentureholders voting at the extraordinary meeting of the Debentureholders voted in favour of an extraordinary resolution pursuant to which all of the Debentures will be settled and all claims of the Debentureholders will be extinguished.

On January 11, 2019, Zargon announced that it had completed a transaction to settle its \$41.94 million principal amount of outstanding 8% convertible unsecured debentures due December 31, 2019 in exchange for Zargon common shares. Pursuant to the transaction, all of the Debentures were settled and all claims of the Debentureholders were extinguished in exchange for an aggregate of 428.88 million common shares, including payment, in the form of common shares, of the accrued and unpaid interest owing on the Debentures from and including September 30, 2018 to but not including January 11, 2019, being the effective date of the completion of the transaction, in each case on the basis of a price of \$0.10 per common share. Immediately before the transaction, 30.93 million common shares were issued and outstanding. Following the completion of the transaction, 459.81 million common shares are issued and outstanding.

## Equity

At March 14, 2019, Zargon Oil & Gas Ltd. had 459.81 million common shares outstanding. Pursuant to the share award plan, there are currently an additional 0.24 million common share awards issued and outstanding.

During 2018, 18.58 million Zargon common shares traded on the Toronto Stock Exchange with a high trading price of \$0.55 per share, a low of \$0.035 per share and a closing price of \$0.04 per share. The 2018 trading statistics show a 69 percent year-over-year increase in trading volume and a 91 percent decrease in the closing share price. Zargon's market capitalization at year end 2018 was approximately \$1 million, compared to approximately \$14 million at the end of 2017.

## Segmented Geographic Information

During 2018, approximately 73 percent (2017 – 81 percent) of Zargon's combined petroleum and natural gas revenue came from Western Canadian (Alberta Plains) properties, with the remaining 27 percent (2017 – 19 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 nil as at December 31, 2018.

## RELATED PARTY TRANSACTIONS

During the year, the Company paid \$0.26 million (2017 – \$0.27 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.

## CONTRACTUAL OBLIGATIONS AND CONTINGENCIES

Zargon has certain contractual obligations relating to the lease of head office space, insurance financing and vehicle leases that extend for longer than one year as set out in the table below:

(\$ millions)	Total	2019	2020 to 2021	2022 to 2023	Thereafter
Head office lease	0.26	0.26	–	–	–
Insurance	0.25	0.25	–	–	–
Vehicle lease and other	0.17	0.04	0.08	0.04	0.01
Total	0.68	0.55	0.08	0.04	0.01

## 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.

The crude oil and natural gas industry is currently subject to environmental regulation under a variety of Canadian federal, provincial, territorial and municipal laws and regulations, all of which are subject to governmental review and revision from time to time. Such regulations provide for, among other things, restrictions and prohibitions on the spill, release or emission of various substances produced in association with certain crude oil and natural gas industry operations, such as sulphur dioxide and nitrous oxide. The regulatory regimes set out the requirements with respect to oilfield waste handling and storage, habitat protection and the satisfactory operation, maintenance, abandonment and reclamation of well and facility sites. Compliance with such regulations can require significant expenditures and a breach of such requirements may result in suspension or revocation of necessary licences and authorizations, civil liability and the imposition of material fines and penalties. In addition to these specific, known requirements, future changes to environmental legislation, including anticipated legislation for air pollution and greenhouse gas ("GHG") emissions, may impose further requirements on operators and other companies in the crude oil and natural gas industry.

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. Further information regarding environmental and climate change regulation is contained in our Annual Information Form.

We have become increasingly dependent upon the availability, capacity, reliability and security of our information technology infrastructure and our ability to expand and continually update this infrastructure, to conduct daily operations. We depend on various information technology systems to estimate reserve quantities, process and record financial data, manage our land base, manage financial resources, analyze seismic information, administer our contracts with our operators and lessees and communicate with employees and third-party partners. Further, we are subject to a variety of information technology and system risks as a part of our normal course operations, including potential breakdown, invasion, virus, cyber-attack, cyber-fraud, security breach, and destruction or interruption of our information technology systems by third parties or insiders. Unauthorized access to these systems by employees or third parties could lead to corruption or exposure of confidential, fiduciary or proprietary information, interruption to communications or operations or disruption to our business activities or our competitive position. In addition, cyber phishing attempts, in which a malicious party attempts to obtain sensitive information such as usernames, passwords, and credit card details (and money) by disguising as a trustworthy entity in an electronic communication, have become more widespread and sophisticated in recent years. If we become a victim to a cyber phishing attack it could result in a loss or theft of our financial resources or critical data and information or could result in a loss of control of our technological infrastructure or financial resources. We apply technical and process controls in line with industry-accepted standards to protect our information assets and systems; however, these controls may not adequately prevent cyber-security breaches. Disruption of critical information technology services, or breaches of information security, could have a negative effect on our performance and earnings, as well as on our reputation. The significance of any such event is difficult to quantify, but may in certain circumstances be material and could have a material adverse effect on our business, financial condition and results of operations.

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 seek 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 15 in the audited consolidated financial statements for the year ended December 31, 2018.

The Government of Alberta's Modernized Royalty Framework ("MRF") will impact the royalty rates paid for our wells drilled after January 1, 2017. Our pre-2017 wells will remain subject to the New Royalty Framework until 2027. The MRF has not had a significant impact on Zargon's operations or financial condition.

There is ongoing uncertainty around the ability for the Western Canadian Sedimentary Basin ("WCSB") producers to reach markets given the status of several proposed pipeline projects, potential for a change to US policies, and potential changes to the crude by rail industry in the face of several derailments.

Zargon's operational results and financial condition, and, therefore, the amount of capital expenditures are dependent on the prices received for oil and natural gas production. The volatility of oil and natural gas prices, uncertainty or modifications regarding royalties and Canadian income tax rules and global economic/political concerns have, on occasion, restricted the oil and natural gas industry's ability to attract new capital from debt and equity markets.

Zargon's operational results and financial condition, and, therefore, the funds available to be allocated to capital expenditures, are dependent on the prices received for oil and natural gas production. The year average 2018 Zargon field oil prices were seven percent higher than the year average 2017 field oil price.

Any movement in oil and natural gas prices will have an effect on Zargon's ability to continue with its capital expenditure program. 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.

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 and local laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on the spill, release or emission of various substances produced in association with oil and gas industry operations. In addition, such legislation sets out the requirements with respect to oilfield waste handling and storage, habitat protection and the satisfactory operation, maintenance, abandonment and reclamation of well and facility sites. Alberta has developed a liability management program designed to prevent taxpayers from incurring costs associated with suspension, abandonment, remediation and reclamation of wells, facilities and pipelines in the event that a licensee or permit holder is unable to satisfy its regulatory obligations. This program involves an assessment of the ratio of a licensee's deemed assets to deemed liabilities. If a licensee's deemed liabilities exceed its deemed assets, a security deposit is generally required. Changes to the required ratio of our deemed assets to deemed liabilities or other changes to the requirements of liability management programs may result in significant increases to our compliance obligations. In addition, the liability management regime may prevent or interfere with our ability to acquire or dispose of assets as both the vendor and the purchaser of oil and gas assets must be in compliance with the liability management programs (both before and after the transfer of the assets) for the applicable regulatory agency to allow for the transfer of such assets. On June 20, 2016, the Alberta Energy Regulator ("AER") issued Bulletin 2016-16 which put in place certain interim measures for transfers of AER regulated assets including a requirement that all transferees demonstrate that they have a Liability Management Rating ("LMR") of 2.0 or higher immediately following the transfer. At March 2, 2019, Zargon's LMR was 1.09. Although there is a significant level of uncertainty around the application of Bulletin 2016-16, it could restrict Zargon from buying or selling oil and gas assets, which could negatively impact its business. The recent Alberta Court of Queen's Bench decision, *Redwater Energy Corporation (Re)* 2016 ABQB 278, found an operational conflict between the Bankruptcy and Insolvency Act and the AER's abandonment and reclamation powers when the licensee is insolvent which was affirmed by a majority of the Alberta Court of Appeal, and has been appealed by the AER to the Supreme Court of Canada for final determination. In response to the decision, the AER issued interim rules to administer the liability management program until the Government of Alberta can develop new regulatory measures to adequately address environmental liabilities. There remains a great deal of uncertainty as to what new regulatory measures will be developed by the provinces or in concert with the federal government, as the final ruling will become binding in all Canadian jurisdictions.

Zargon's strategic alternatives process is continuing and may include, but is not limited to a merger or other business combination, a restructuring of the Company's current capital structure, the addition of capital to further develop the potential of the assets, the sale of the Company or a portion of the Company's assets or any combination thereof, as well as the continued execution of its business plan.

## 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 award and stock option 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 retained 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 Consolidated Financial Statements.

## FUTURE CHANGES IN ACCOUNTING POLICIES

The Company's future changes in accounting policies are discussed in Note 4 to the Consolidated 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 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, 2018.
- The President and Chief Executive Officer and 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, 2018.

- Zargon reports that no changes were made to ICFR during 2017 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 operations. 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 2018.

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. In 2016, Zargon adopted the 2013 Committee of Sponsoring Organizations of the Treadway Commission ("COSO") Framework.

## OUTLOOK

The outlook for Zargon's projected cash flows have improved with the settlement of our \$41.94 million principal amount of convertible debentures and the narrowing of the 2019 WTI-WCS differentials.

In 2015 Zargon formed a Special Board Committee (the "Committee") to examine alternatives available to maximize shareholder value. Macquarie Capital Markets Canada Ltd. ("Macquarie") is currently engaged as Zargon's exclusive financial advisor to evaluate strategic alternatives available to Zargon which may include a sale of the Company or a portion of the Company's assets, a restructuring of the Company's current capital structure, the addition of capital to further develop the potential of the assets, a merger, a farm-in or joint venture, or other such options as may be determined by the Board of Directors to be in the best interests of the Company and its stakeholders.

## SUMMARY OF QUARTERLY RESULTS

	2018			
	Q1	Q2	Q3	Q4
Petroleum and natural gas sales (\$ millions)	9.71	10.84	10.17	<b>4.77</b>
Net loss (\$ millions)	(4.33)	(1.68)	(0.64)	<b>(28.71)</b>
Net loss per diluted share (\$)	(0.14)	(0.05)	(0.02)	<b>(0.93)</b>
Funds flow from/(used in) operating activities (\$ millions)	(0.30)	0.58	1.93	<b>(2.74)</b>
Funds flow from/(used in) operating activities per diluted share (\$)	(0.01)	0.02	0.06	<b>(0.09)</b>
Cash flows from/(used in) operating activities (\$ millions)	0.80	1.98	0.85	<b>(2.41)</b>
Cash flows from operating activities per diluted share (\$)	0.03	0.06	0.03	<b>(0.08)</b>
Net capital expenditures (\$ millions)	1.50	1.19	0.93	<b>0.68</b>
Total assets (\$ millions)	136.83	135.80	132.96	<b>108.41</b>
Debt	–	–	–	<b>4.97</b>
Convertible debentures (\$ millions) <sup>(1)</sup>	41.94	41.94	41.94	<b>41.94</b>
Net debt	40.79	41.54	40.78	<b>45.17</b>
Average daily oil and liquids production (bbl)	1,949	1,805	1,680	<b>1,575</b>
Average daily natural gas production (mmcf)	2.87	1.88	1.64	<b>1.27</b>
Average daily production (boe)	2,427	2,118	1,953	<b>1,786</b>
Average oil production weighting (%)	80	85	86	<b>88</b>
Average realized commodity field price before the impact of financial risk management contracts (\$/boe)	44.47	56.23	56.61	<b>28.99</b>
Funds flow netback (\$/boe)	(1.38)	2.98	10.76	<b>(16.69)</b>

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

	2017			
	Q1	Q2	Q3	Q4
Petroleum and natural gas sales (\$ millions)	9.69	9.40	9.28	10.31
Net loss (\$ millions)	(0.54)	(1.71)	(3.51)	(3.55)
Net loss per diluted share (\$)	(0.02)	(0.06)	(0.11)	(0.12)
Funds flow from operating activities (\$ millions)	1.50	1.14	1.76	1.59
Funds flow from operating activities per diluted share (\$)	0.05	0.04	0.06	0.05
Cash flows from/(used in) operating activities (\$ millions)	2.52	(0.59)	0.25	0.29
Cash flows from/(used in) operating activities per diluted share (\$)	0.08	(0.02)	0.01	0.01
Net capital expenditures (\$ millions)	2.51	2.13	1.77	2.45
Total assets (\$ millions)	153.75	150.11	144.76	140.55
Convertible debentures (\$ millions) <sup>(1)</sup>	41.94	41.94	41.94	41.94
Net debt	35.09	36.06	36.70	38.41
Average daily oil and liquids production (bbl)	2,016	1,921	2,037	1,924
Average daily natural gas production (mmcf)	3.38	3.47	3.55	2.95
Average daily production (boe)	2,579	2,500	2,628	2,416
Average oil production weighting (%)	78	77	78	80
Average realized commodity field price before the impact of financial risk management contracts (\$/boe)	41.74	41.34	38.36	46.37
Funds flow netback (\$/boe)	6.48	5.00	7.28	7.17

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

## FOURTH QUARTER 2018

During the fourth quarter of 2018, Zargon's petroleum and natural gas sales of \$4.77 million were 53 percent lower than the previous quarter's sales. Production for the 2018 fourth quarter of 1,786 barrels of oil equivalent per day was nine percent lower than the 2018 third quarter's production of 1,953 barrels of oil equivalent per day. Compared to the previous quarter, oil production was six percent lower at 1,575 barrels per day. The fourth quarter natural gas production decreased 23 percent from the previous quarter to 1.27 million cubic feet per day. Average field prices received during the fourth quarter were \$31.74 per barrel for oil and liquids, a 51 percent decrease compared to the 2018 third quarter and \$1.42 per thousand cubic feet for natural gas, a 42 percent increase from the prior quarter.

Funds flow was a negative \$2.74 million in the fourth quarter, a decrease of \$4.67 million from the prior quarter. A comparative analysis of the primary factors that caused this quarter-over-quarter decrease is as follows:

- Fourth quarter 2017 petroleum and natural gas sales of \$4.77 million were 53 percent lower than the 2018 third quarter sales of \$10.17 million. This sales decrease was a result of the 51 percent decrease in oil and liquids pricing (due to the WCS differential increasing to record levels in November and December 2018 due to an increased supply of crude oil from western Canada, refinery turnarounds in the US, and a lack of pipeline capacity in western Canada) and a nine percent decrease in production, which was partially offset by a 42 percent increase in natural gas pricing over the third quarter.
- Royalties for the fourth quarter were \$0.72 million, a decrease of \$0.83 million from the prior quarter as the average royalty rate for the quarter decreased to a 15.0 percent from the 2018 third quarter rate of 15.1 percent.
- Operating expenses were \$4.58 million for the quarter, four percent lower than the third quarter of 2018. Transportation expenses were \$0.10 million, a 13 percent decrease over the prior quarter. The quarterly decrease in operating expenses was due to a decrease in well workovers and lower production. On a per barrel of oil equivalent basis, operating expenses increased five percent to \$27.87 in the fourth quarter of 2018 compared to \$26.50 in the prior quarter and transportation expenses decreased six percent to \$0.61 from \$0.65 in the prior quarter.
- General and administrative expenses of \$0.88 million for the quarter included \$0.13 million of one-time employment costs, were nine percent higher than the third quarter of 2018. General and administrative expenses on a per barrel of oil equivalent basis were \$5.37 compared to \$4.50 in the prior quarter.
- Transaction costs incurred in the fourth quarter were \$0.07 million compared to \$0.07 million in the prior quarter. The transaction costs relate to Zargon's ongoing strategic alternatives review.
- Interest and financing charges on debt were \$0.34 million, an increase from the prior quarter of nil, and relate to the \$3.50 million (USD) term debt obtained in November 2018. Interest on convertible debentures was \$0.84 million and was consistent with the prior quarter expense.
- The current tax recovery was \$0.02 million, compared to \$0.11 million of the expense in the 2018 third quarter.

The net loss for the quarter was \$28.71 million, compare to the prior quarter net loss of \$0.64 million. The net earnings tracks the funds flow from operating activities for the respective periods modified by non-cash charges, which included the following for the fourth quarter of 2018:

- Depletion and depreciation expense decreased by \$0.08 million to \$2.61 million in the 2018 fourth quarter. The decreased expense was due to a year end decrease in production volumes and future capital expenditures offset by a decrease in year over year reserves.
- Accretion of convertible debentures remained unchanged at \$0.12 million in the 2018 fourth quarter compared to the prior quarter amount.

- The provision for accretion of asset retirement obligations for the 2018 fourth quarter was \$0.36 million, which is consistent with the prior quarter expense.
- Share-based compensation expense was \$0.04 million during the fourth quarter of 2018 compared to \$0.02 million in the prior quarter expense.
- Unrealized foreign exchange gains was nil in the 2018 fourth quarter compared to a gain of \$0.02 million for the prior quarter.
- At the end of the fourth quarter, the Company tested its CGUs for impairment. Low crude oil and natural gas prices resulted in \$21.16 million of impairment in the Alberta Plains South CGU. The E&E assets associated with these CGUs were not included in this impairment test and were tested separately.
- At the end of the fourth quarter, the Company tested its E&E assets for impairment. The carrying amounts of the CGUs were tested and determined to be \$1.82 million higher than their fair value of nil and an impairment loss was recognized.
- The deferred tax recovery was \$0.20 million during the quarter compared to a deferred tax recovery of \$0.07 million from the third quarter of 2018.

Net capital expenditures were \$0.68 million during the fourth quarter of 2018, compared to a prior quarter spend amount of \$0.93 million. Fourth quarter conventional expenditures were \$0.66 million while ASP expenditures were \$0.41 million (including \$0.38 million of chemical costs). In additions to these expenditures, Zargon had net acquisitions of \$0.02 million in the quarter. During the fourth quarter, Zargon drilled nil net wells.

Asset retirement expenditures reflect the actual amounts incurred to abandon and reclaim wells. These asset retirement expenditures totalled \$0.85 million in the 2018 fourth quarter and increased 254 percent from the prior quarter amount of \$0.24 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 professional 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



**W.T. Cromb**  
Chief Financial Officer

Calgary, Canada  
March 14, 2019

# INDEPENDENT AUDITORS' REPORT

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

## **Opinion**

We have audited the consolidated financial statements of Zargon Oil and Gas Limited and its subsidiaries (the "Group"), which comprise the consolidated statement of financial position as at December 31, 2018 and December 31, 2017, and the consolidated statements of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the years then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects the consolidated financial position of the Group as at December 31, 2018 and December 31, 2017, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards (IFRS).

## **Basis for Opinion**

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in Canada, and we have fulfilled our ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

## **Material Uncertainty Related to Going Concern**

We draw attention to Note 2(d) in the consolidated financial statements, which indicates that the Group incurred a net loss of \$35.37 million during the year ended December 31, 2018 and, as of that date, the Group's current assets exceeded its total current liabilities by \$1.24 million. As stated in Note 2(d), these events or conditions, along with other matters as set forth in Note 2(d), indicate that a material uncertainty exists that may cast significant doubt on the Group's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

## **Other information included in the Group's 2018 Annual Report**

Management is responsible for the other information. The other information comprises:

- Management's Discussion and Analysis.
- The information, other than the consolidated financial statements and our auditor's report thereon, in the Annual Report.

Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information, and in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

We obtained Management's Discussion & Analysis prior to the date of this auditor's report. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

The Annual Report is expected to be made available to us after the date of the auditor's report. If based on the work we will perform on this other information, we conclude there is a material misstatement of other information, we are required to report that fact to those charged with governance.

## **Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements**

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with IFRSs, 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.

In preparing the consolidated financial statements, management is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group's financial reporting process.

### **Auditor's Responsibilities for the Audit of the Consolidated Financial Statements**

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

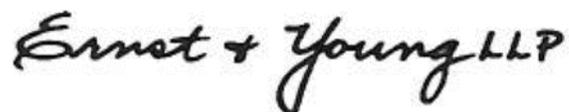
As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Group's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure, and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

The engagement partner on the audit resulting in this independent auditor's report is Robert James Eyton Mitchell.

The logo for Ernst & Young LLP, featuring the company name in a stylized, handwritten-style script.

Chartered Professional Accountants  
Calgary, Canada  
March 14, 2019

# CONSOLIDATED BALANCE SHEETS

(\$ thousands)	Notes	December 31, 2018	December 31, 2017
<b>ASSETS</b>			
Cash and cash equivalents		5,055	4,095
Trade and other receivables		866	3,888
Deposits and prepaid expenses		1,817	1,908
<b>Total current assets</b>		<b>7,738</b>	<b>9,891</b>
Long term deposits		20	18
Property, plant and equipment, net	5,7	100,649	128,908
Intangible exploration and evaluation assets	6	–	1,735
<b>Total assets</b>		<b>108,407</b>	<b>140,552</b>
<b>LIABILITIES</b>			
Trade and other payables		5,989	6,362
Debt	9	512	–
Derivatives	15,16	–	1,151
<b>Total current liabilities</b>		<b>6,501</b>	<b>7,513</b>
Debt	9	4,407	–
Convertible debentures	10, 26	41,421	41,461
Asset retirement obligations	8	63,412	64,812
Deferred tax liabilities	17	4,009	4,045
<b>Total liabilities</b>		<b>119,750</b>	<b>117,831</b>
Commitments and contingencies	8,9,10,14,16,25		
<b>EQUITY</b>			
Shareholders' capital	13	262,735	262,231
Accumulated other comprehensive income		5,062	4,412
Contributed surplus	14	9,288	9,651
Equity component of debentures	10, 26	3,570	3,570
Deficit		(291,998)	(257,143)
<b>Total equity</b>		<b>(11,343)</b>	<b>22,721</b>
<b>Total equity and liabilities</b>		<b>108,407</b>	<b>140,552</b>

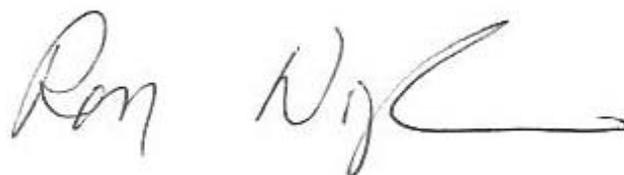
*Going concern (see Note 2(d))*

*See accompanying notes to the consolidated financial statements.*

Dated on March 14, 2019 on behalf of the Board:



K.D. Kitagawa, Director



R. Wigham, Director

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

For the years ended December 31 (\$ thousands, except per share amounts)	Notes	2018	2017
Petroleum and natural gas sales	12	35,485	38,675
Royalties		(5,107)	(4,435)
<b>PETROLEUM AND NATURAL GAS REVENUE, NET OF ROYALTIES</b>		<b>30,378</b>	<b>34,240</b>
Gain on unrealized derivatives	15,16	1,151	798
Loss on realized derivatives	15,16	(2,406)	(377)
<b>(LOSS)/GAIN ON DERIVATIVES</b>		<b>(1,255)</b>	<b>421</b>
<b>TOTAL INCOME</b>		<b>29,123</b>	<b>34,661</b>
Operating	12	20,386	19,683
Transportation		431	454
General and administrative		3,624	4,162
Transaction costs		282	239
Exploration and evaluation	6	–	393
Gain on convertible debentures		–	(458)
Gain on disposal of properties	5	(1)	(4)
Share-based compensation	14,18	141	366
Unrealized foreign exchange (gain)/loss		(124)	73
Impairment loss on property, plant and equipment	5,7	21,163	1,797
Impairment loss on exploration and evaluation	6	1,815	244
Impairment loss on marketable securities		–	185
Depletion and depreciation	5	11,412	13,470
<b>EXPENSES</b>		<b>59,129</b>	<b>40,604</b>
<b>LOSS BEFORE FINANCE EXPENSES AND INCOME TAXES</b>		<b>(30,006)</b>	<b>(5,943)</b>
Interest and financing charges	9	348	(12)
Interest on convertible debentures	10, 26	3,352	3,373
Accretion of debt	9	25	–
Accretion of convertible debentures	10, 26	473	595
Accretion of asset retirement obligations	8	1,450	1,475
<b>FINANCE EXPENSES</b>		<b>5,648</b>	<b>5,431</b>
<b>LOSS BEFORE INCOME TAXES</b>		<b>(35,654)</b>	<b>(11,374)</b>
Current tax expense/(recovery)	17	85	(29)
Deferred tax recovery	17	(371)	(2,035)
<b>INCOME TAXES RECOVERY</b>		<b>(286)</b>	<b>(2,064)</b>
<b>NET LOSS FOR THE YEAR</b>		<b>(35,368)</b>	<b>(9,310)</b>
Currency translation adjustment recognized in other comprehensive loss		650	(490)
<b>OTHER COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR</b>		<b>650</b>	<b>(490)</b>
<b>TOTAL COMPREHENSIVE LOSS FOR THE YEAR</b>		<b>(34,718)</b>	<b>(9,800)</b>
<b>NET LOSS PER SHARE</b>			
Basic	19	(1.15)	(0.30)
Diluted	19	(1.15)	(0.30)

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
Balance at December 31, 2017		262,231	4,412	9,651	3,570	(257,143)	22,721
Net loss for the year		-	-	-	-	(35,368)	(35,368)
Share-based compensation	14	-	-	141	-	-	141
Exercise of share awards	13	504	-	(504)	-	-	-
Convertible debenture IFRS 9 adoption		-	-	-	-	513	513
Translation differences on foreign subsidiary		-	650	-	-	-	650
<b>Balance at December 31, 2018</b>		<b>262,735</b>	<b>5,062</b>	<b>9,288</b>	<b>3,570</b>	<b>(291,998)</b>	<b>(11,343)</b>
Balance at December 31, 2016		260,902	4,902	10,614	3,640	(247,833)	32,225
Net loss for the year		-	-	-	-	(9,310)	(9,310)
Share-based compensation	14	-	-	366	-	-	366
Exercise of share awards	13	1,329	-	(1,329)	-	-	-
Equity component of convertible debentures		-	-	-	(70)	-	(70)
Translation differences on foreign subsidiary		-	(490)	-	-	-	(490)
Balance at December 31, 2017		262,231	4,412	9,651	3,570	(257,143)	22,721

*See accompanying notes to the consolidated financial statements.*

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31 (\$ thousands)	Notes	2018	2017
<b>OPERATING ACTIVITIES</b>			
Net loss for the year		<b>(35,368)</b>	(9,310)
Adjustments for non-cash items:			
Gain on convertible debentures	10	–	(458)
Gain on sale of properties	5	<b>(1)</b>	(4)
Gain on unrealized derivatives	15,16	<b>(1,151)</b>	(798)
Depletion and depreciation	5	<b>11,412</b>	13,470
Accretion of asset retirement obligations	8	<b>1,450</b>	1,475
Accretion of convertible debentures	10, 26	<b>473</b>	595
Accretion of debt		<b>25</b>	–
Share-based compensation	14	<b>141</b>	366
Unrealized foreign exchange (gain)/loss		<b>(124)</b>	73
Impairment loss on property, plant and equipment	5,7	<b>21,163</b>	1,797
Impairment loss on exploration and evaluations	6	<b>1,815</b>	244
Impairment loss on marketable securities		–	185
Deferred tax recovery	17	<b>(371)</b>	(2,035)
Exploration and evaluation	6	–	393
Funds flow (used)/from operating activities		<b>(536)</b>	5,993
Asset retirement expenditures	8	<b>(1,944)</b>	(2,114)
Changes in operating working capital	20	<b>3,703</b>	(1,395)
Net cash flows from operating activities		<b>1,223</b>	2,484
<b>INVESTING ACTIVITIES</b>			
Additions to property, plant and equipment	5	<b>(4,627)</b>	(8,591)
Additions to intangible exploration and evaluation assets	6	<b>(71)</b>	(164)
Proceeds from disposal of property, plant and equipment	5	<b>395</b>	(110)
Change in long term deposits		<b>(2)</b>	310
Changes in investing working capital	20	<b>(760)</b>	728
Net cash flows used in investing activities		<b>(5,065)</b>	(7,827)
<b>FINANCING ACTIVITIES</b>			
Advances of debt	9	<b>4,802</b>	–
Redemption of convertible debentures, including transaction costs	10	–	(15,417)
Net cash flows from/(used) in financing activities		<b>4,802</b>	(15,417)
<b>NET CHANGE IN CASH DURING THE YEAR</b>		<b>960</b>	(20,760)
<b>CASH, BEGINNING OF YEAR</b>		<b>4,095</b>	24,855
<b>CASH, END OF YEAR</b>		<b>5,055</b>	4,095

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, 2018 with comparative figures for 2017.

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 1100, 112 - 4<sup>th</sup> Avenue SW, Calgary, Alberta. The consolidated financial statements of the Company as at and for the years ended December 31, 2018 and its 2017 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 AND GOING CONCERN

### (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 14, 2019.

### (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.

### (d) Going Concern:

These financial statements have been prepared in accordance with generally accepted accounting principles applicable to a going concern, which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business. For the year ended December 31, 2018, the Company has working capital of \$1.75 million (defined as current assets less accounts payable), positive cash flows from operating activities of \$1.22 million and generated a net loss of \$35.37 million. Sustained low commodity prices in recent months have put pressure on the Company’s cash flows. Specifically, the WCS differential increased to record levels in November and December 2018 due to an increased supply of crude oil from western Canada, refinery turnarounds in the US, and a lack of pipeline capacity in western Canada which resulted in the deterioration of Company projections on cash flows. As a result, there is material uncertainty related to future events that may cast substantial doubt on the Company’s ability to continue as a going concern and therefore, it may be unable to realize its assets and discharge its liabilities in the normal course of business. The continuation of the Company as a going concern is dependent upon the occurrence of all or some of these future events: actual prices exceeding the current estimates in the coming six months, accessing additional capital, or other unforeseen events. In an effort to mitigate these challenges, the Company obtained \$3.50 (USD) of term debt in November 2018, and furthermore in January 2019 the Company settled its outstanding \$41.94 million convertible debentures, thereby eliminating \$4.20 million of debenture interest payments that were due and payable in 2019. These financial statements do not reflect adjustments that would be necessary if the going concern assumption were not appropriate. If the going concern basis were not appropriate for these financial statements, then adjustments would be necessary in the carrying value of the assets and liabilities, the reported revenues and expenses, and the balance sheet classifications used. These adjustments could be material.

### 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 and long term debt are designated as “other liabilities”. The fair value of long term 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 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 is designated as a “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 through the consolidated statement of earnings/(loss).

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 through the consolidated statement of other comprehensive income/(loss). 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.

v) Income taxes:

Tax regulations and legislation are subject to change and differing interpretations requiring management judgment. Deferred tax assets are recognized when it is considered probable that deductible temporary differences will be recovered in future periods based on future taxable profits, which requires management judgment. Deferred tax liabilities are recognized when it is considered probable that temporary differences will be payable to tax authorities in future periods, which requires management judgment. Income tax filings are subject to audits and re-assessments and changes in facts, circumstances and interpretations of the standards may result in a material increase or decrease in the Company’s provision for income taxes.

#### 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 a gain.

(ii) Jointly controlled operations and jointly controlled assets:

A joint operation is a contractual arrangement whereby two or more parties 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 operators. Many of the Company's oil and natural gas activities involve jointly controlled assets and liabilities. The consolidated financial statements include the Company's share of these jointly controlled assets and liabilities 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 the functional currency at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated to the functional currency at the period end exchange rate. Foreign currency differences arising on translation are recognized in earnings.

Zargon's functional and presentation currency is Canadian dollars.

(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 the period average rates of exchange. 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 intangible 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 and 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 productivity 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. 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. Finance leases are capitalized at the commencement of the lease term at the present value of the minimum lease payments and depreciated over the lease term. All other leases are classified as operating leases, which are not recognized on the Company's consolidated balance sheet.

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.

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 IFRS 9 "Financial Instruments" 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 inflows of that asset.

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between the carrying amount and the present value of the estimated future cash inflows, discounted using the original effective interest rate, according to the expected credit loss model.

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 is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized.

(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 of disposal.

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.

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 expenses 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 plan and stock option plan, 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, loans and borrowings, and trade and other payables. Non-derivative financial instruments are recognized initially at fair value plus, any directly attributable transaction costs. Subsequent to initial recognition non-derivative financial instruments are measured as described below.

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.

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 measured based on the consideration specified in contracts with buyers. Revenue from contracts is recognized when or as Zargon satisfies a performance obligation by transferring a promised good or service to a buyer. A good or service is transferred when the buyer obtains control of that good or service. The transfer of control of oil, natural gas, natural gas liquids usually coincides with the title passing to the buyer and the buyer taking physical possession. The transaction price for variable price contracts is based on the commodity price, adjusted for quality, location and other factors.

(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 the consolidated statement of earnings/(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) 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.

(o) Changes in accounting policy and disclosure

(i) New and amended standards were adopted by the Company for the year ended December 31, 2018:

- On January 1, 2018, Zargon adopted IFRS 9 “Financial Instruments”. IFRS 9 replaces the former 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. The Company has evaluated the impact of adopting IFRS 9 and has concluded that the new standard has the following impacts on the company:
  - i. IFRS 9 has revised the method to account for convertible debenture modifications by removing the option to defer and amortize the difference in present values between the pre-modified cash flows and the new cash flows over the remaining life of the newly modified liability, and as such, the carrying value of the convertible debenture was adjusted on January 1, 2018 to conform to IFRS 9.
  - ii. Classification  
Financial instruments are recognized initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition, financial instruments are measured based on their classification as described below:
    - 1. Fair value through profit or loss: Financial instruments under this classification include derivative asset and liabilities.
    - 2. Amortized cost: Financial instruments under this classification include cash, accounts receivable, accounts payable and long term debt.
  - iii. Impairment  
IFRS 9 replaces the “incurred loss” model under IAS 39 with an “expected credit loss” model for financial assets carried at amortized cost, and fair value through OCI. Zargon has applied the expected credit loss model to financial assets classified as amortized cost using the simplified approach applying a provision matrix whereby accounts are grouped into categories based on counterparty characteristics and aging categories. The application of the expected credit loss model did not result in an adjustment upon transition.
- On January 1, 2018, Zargon adopted IFRS 15 “Revenue from Contracts with Customers”, which 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. The Company has assessed the impact of adopting IFRS 15 and there is no material impact on the Company’s consolidated financial statements. As a result of this adoption, Zargon has revised the description of its accounting policy for revenue recognition as follows:

Revenue recognition

Revenue from the sale of crude oil, natural gas and natural gas liquids is measured based on the consideration specified in contracts with buyers. Revenue from contracts is recognized when or as Zargon satisfies a performance obligation by transferring a promised good or service to a buyer. A good or service is transferred when the buyer obtains control of that good or service. The transfer of control of oil, natural gas, natural gas liquids usually coincides with the title passing to the buyer and the buyer taking physical possession. The transaction price for variable price contracts is based on the commodity price, adjusted for quality, location and other factors.

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

- IFRS 16 “Leases”, was issued by the IASB in January 2016, which replaces IAS 17 “Leases”. Under the current guidance, lessees are required to determine if the lease is a finance or operating lease, based on specified criteria. Finance leases are recognized on the consolidated balance sheet while operating leases are recognized in the consolidated statement of earnings when the expense is incurred. Under IFRS 16, lessees must recognize a lease liability and a right-of-use asset for virtually all lease contracts. The recognition of the present value of minimum lease payments for certain contracts currently classified as operating leases will result in increases to assets, liabilities, depletion and depreciation expense, and finance expense, and a decrease to operating expense upon implementation. An optional exemption to not recognize certain short-term leases of low value can be applied by lessees. For lessors, the accounting remains essentially unchanged. The standard will come into effect for annual periods beginning on or after January 1, 2019, with earlier adoption permitted if the entity is also applying IFRS 15 “Revenue from Contracts with Customers”. IFRS 16 will be applied by Zargon on January 1, 2019 and the Company is currently assessing the impact of adopting IFRS 16 on the Company’s consolidated financial statements. The Company will adopt the transition to IFRS 16 using the modified retrospective approach.

## 5. PROPERTY, PLANT AND EQUIPMENT

(\$ thousands)	2018	2017
Cost, beginning of year	295,292	291,731
Accumulated depletion and depreciation, beginning of year	(166,384)	(154,252)
Net carrying amount, beginning of year	128,908	137,479
Additions	4,627	8,724
Disposals	(276)	–
Change in asset retirement obligation	(1,484)	(800)
Impairment loss on property, plant and equipment (Note 7)	(21,163)	(1,797)
Exchange differences	1,449	(1,228)
Depletion and depreciation	(11,412)	(13,470)
Net carrying amount, end of year	100,649	128,908
Cost, end of year	280,065	295,292
Accumulated depletion and depreciation, end of year	(179,416)	(166,384)
Net carrying amount, end of year	100,649	128,908

### (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).

### (b) 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, 2018, the Company disposed of certain assets for gross cash proceeds of \$0.40 million (2017 – nil), resulting in a gain of nil (2017 – nil).

## 6. INTANGIBLE EXPLORATION AND EVALUATION ASSETS

(\$ thousands)	2018	2017
Balance, beginning of the year	1,735	2,226
Additions	71	164
Exploration and evaluation expense	–	(393)
Impairment loss	(1,815)	(244)
Exchange differences	9	(18)
Balance, end of year	–	1,735

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 thereof, is recognized as impairment expense in the consolidated statement of earnings/(loss) and comprehensive income/(loss). Based on the assessment on December 31, 2018, the carrying amounts of the three CGUs were tested and determined to be \$1.82 million higher than their fair value of nil, and an impairment loss was recognized and the balance was written-off. The impairment specifically related to Alberta Plains North (\$0.64 million) and Alberta Plains South (\$0.78 million) and Williston Basin USA (\$0.40 million).

### (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 ON PROPERTY, PLANT AND EQUIPMENT

As at December 31, 2018, the Company tested its CGUs, as defined under IFRS, for impairment. Low crude oil and natural gas prices resulted in impairment in the Alberta Plains South CGU. 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 of disposal. The estimate of fair value less costs of disposal was determined using an after-tax discount rate of 10 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 costs of disposal 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>
2019	56.50	1.85	0.750
2020	63.80	2.20	0.775
2021	67.60	2.55	0.800
2022	71.60	3.05	0.800
2023	73.10	3.20	0.800
2024	74.50	3.30	0.800
2025	76.00	3.35	0.800
2026	77.50	3.40	0.800
2027	79.10	3.45	0.800
2028	80.70	3.55	0.800
2029	82.30	3.60	0.800
2030	83.90	3.70	0.800
2031	85.60	3.75	0.800
2032	87.30	3.80	0.800
2033	89.10	3.90	0.800
Remainder <sup>(2)</sup>	2.0%	2.0%	0.800

(1) Source: McDaniel & Associates Consultants Ltd. price forecast effective January 1, 2019.

(2) Percentage change represents the change in each year after 2033 to the end of the reserve life.

Based on the assessment on December 31, 2018, the carrying amount of the Alberta Plains South CGU was determined to be \$21.16 million higher than its recoverable amount, and an impairment loss was recognized. The carrying amounts after impairment and impairment reversal as at December 31, 2018 were \$23.10 million, \$56.03 million, and \$21.52 million for the Alberta Plains North, Alberta Plains South, and Williston Basin USA CGUs, respectively.

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 \$2.21 million.
- A five percent decrease in future planned cash flows would have increased the impairment loss by \$2.80 million.

The estimated recoverable amount of the impaired CGUs is classified as a Level III fair value measurement. Refer to Note 3(iv) for information on fair value hierarchy classifications. In 2017, the Company determined there was \$1.80 million in impairment.

## 8. ASSET RETIREMENT OBLIGATIONS

(\$ thousands)

Balance at December 31, 2017	<b>64,812</b>
Foreign exchange and other	<b>578</b>
Asset retirement expenditures	<b>(1,944)</b>
Asset retirement obligations related to dispositions	<b>(122)</b>
Revisions to estimated asset retirement obligations	<b>(1,362)</b>
Accretion	<b>1,450</b>
Balance at December 31, 2018	<b>63,412</b>

(\$ thousands)

Balance at December 31, 2016	66,749
Foreign exchange and other	(498)
Asset retirement expenditures	(2,114)
Revisions to estimated asset retirement obligations	(800)
Accretion	1,475
<b>Balance at December 31, 2017</b>	<b>64,812</b>

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 \$67.37 million as at December 31, 2018. 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 2018, the discount factor was 2.25 percent (2017 – 2.25 percent) based on the Government of Canada long term bond rate. An inflation rate of two percent per annum (2017 – two percent) used in the calculation of the present value of the asset retirement obligation remains unchanged.

#### 9. DEBT

(\$ thousands)	December 31, 2018	December 31, 2017
Debt (\$Cdn)	4,802	–
Capital lease obligation <sup>(1)</sup>	117	–
<b>Total debt</b>	<b>4,919</b>	<b>–</b>
Current (\$Cdn)	512	–
Non-current	4,407	–

(1) Capital lease obligation relates to trucks acquired in the year.

On November 2, 2018 the Company entered into a financing agreement for \$3.50 million (USD) term debt. The terms of the loan are:

- The loan is secured by the Zargon's North Dakota assets.
- The loan bears interest at 11%.
- Principal repayments commence July 1, 2019 at \$0.05 million (USD) per month until September 1, 2019 and on October 1, 2019 principal repayments will be \$0.08 million (USD) per month until maturity at April 1, 2020 when the balance of the principal plus an original issue discount of \$0.15 million (USD) is payable.
- The loan may be prepaid at any time, but is subject to make whole prepayment interest penalties calculated on the lesser of the remaining term of the loan or 12 months, which includes the four percent original issue discount.
- Additional payments of 8% of incremental revenue earned (after payment of royalties) in excess of a \$63.50 (USD) per barrel field price threshold, will also be made to the lender.
- If Zargon's North Dakota monthly production is less than 300 barrels of oil per day but exceeds 240 barrels of oil per day or if the Zargon's North Dakota properties EBITDA in a trailing 12 month period is less than \$1.75 million (USD) but exceeds \$1.25 million (US), the Company is required to make an additional monthly principal repayment of \$0.08 million (USD).
- If Zargon's North Dakota's monthly production is less than 240 barrels of oil per day or if Zargon's North Dakota properties EBITDA in a trailing 12 month period is less than \$1.25 million US, the lender may demand immediate payment of the loan, accrued interest, and any applicable make whole payment.

A four percent original issue discount on the \$3.50 million (USD) term debt is payable upon maturity. The principal balance will accrete up to the face amount which includes the four percent original issue discount of \$0.15 million (USD). A reconciliation of the principal and accretion is provided below:

(\$ thousands)	December 31, 2018	December 31, 2017
Principal, beginning of year (\$Cdn)	–	–
Debt (\$Cdn)	4,777	–
Accretion of debt (\$Cdn)	25	–
Principal, end of period (\$Cdn)	4,802	–

#### 10. CONVERTIBLE DEBENTURES

On May 1, 2012, Zargon completed the issuance of convertible unsecured subordinated debentures (the "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 bore interest at a rate of six percent per annum, which was payable semi-annually, in arrears, on June 30 and December 31 of each year which commenced December 31, 2012. The debentures were convertible at the holder's option into common shares of Zargon at a conversion price of \$18.80 per common share and were to mature on June 30, 2017.

After June 30, 2015, Zargon could have redeemed the debentures in whole or in part provided the common shares' weighted average trading price during a specified period prior to redemption was not less than 125 percent of the conversion price. Zargon could also have redeemed the debentures on June 30, 2017 with cash or through the issuance of Zargon common shares priced at 95 percent of the current market price of the common shares on the maturity date.

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).

As of February 14, 2017, amendments to the debentures (the "amended debentures") took effect and were approved by the Debentureholders at a meeting held February 14, 2017. The debentures now have an annual interest rate of eight percent effective April 1, 2017 which is payable semi-annually, in arrears, on March 31 and September 30 of each year, a conversion price of \$1.25, a maturity date of December 31, 2019. The amendments were accounted for as a modification.

On March 31, 2017, Zargon took up \$15.56 million aggregate principal amount of its six percent convertible unsecured subordinated debentures at tender prices ranging from \$890 to \$1,000 per \$1,000 principal amount of debentures, for a total cash consideration of \$14.84 million, which was equivalent to an average cost of \$954 per debenture. The redemption of the debentures was completed pursuant to the Company's previously announced redemption of up to \$19.00 million aggregate principal amount of debentures at cash prices determined by a "Dutch auction" process (the "Redemption Auction").

The amended debentures commenced trading on the Toronto Stock Exchange under the new symbol "ZAR.DB.A" at the open of markets on April 3, 2017. After giving effect to the Redemption Auction, there was approximately \$41.94 million aggregate principal amount of the amended debentures outstanding.

(\$ thousands)	December 31, 2018	December 31, 2017
Principal, beginning of year	41,941	57,500
Redemption	–	(15,559)
Principal, end of year	41,941	41,941
Debt component, beginning of year	41,461	56,671
Cash consideration	–	(14,842)
Gain on convertible debenture	–	(458)
Transaction costs	–	(505)
IFRS 9 adoption	(513)	
Accretion of convertible debentures	473	595
Debt component, end of year	41,421	41,461
Equity component, beginning of year	3,570	3,640
Transaction costs	–	(70)
Equity component, end of year	3,570	3,570

On November 21, 2018, Zargon announced the proposed transaction to settle its convertible debentures.

On January 10, 2019, Zargon announced that 82.64% of debentureholders voting at the extraordinary meeting of the debentureholders voted in favour of an extraordinary resolution pursuant to which all of the debentures will be settled and all claims of the debentureholders will be extinguished.

On January 11, 2019, Zargon announced that it had completed a transaction to settle its \$41.94 million principal amount of outstanding 8% convertible unsecured debentures due December 31, 2019 in exchange for Zargon common shares. Pursuant to the transaction, all of the Debentures were settled and all claims of the debentureholders were extinguished in exchange for an aggregate of 428.88 million common shares, including payment, in the form of common shares, of the accrued and unpaid interest owing on the Debentures from and including September 30, 2018 to but not including January 11, 2019, being the effective date of the completion of the transaction, in each case on the basis of a price of \$0.10 per common share. Immediately before the transaction, 30.93 million common shares were issued and outstanding. Following the completion of the transaction, 459.81 million common shares are issued and outstanding.

## 11. CAPITAL DISCLOSURES

The Company's capital structure is comprised of shareholders' equity plus 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.

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 the full future face value of the convertible debenture of \$41.94 million (December 31, 2017 – \$41.94 million) and the full future face value of the term debt of \$4.97 million (December 31, 2017 – nil) and any working capital excluding the unrealized derivative assets/liabilities. Funds flow from operating activities represent net earnings/loss adjusted for non-cash items.

On January 11, 2019, Zargon announced that it had completed a transaction to settle its \$41.94 million principal amount of outstanding convertible debentures. The Company views this transaction as a significant change in the composition of the entity and its capital structure, and as such has disclosed an adjusted net debt calculation that removes the \$41.94 million full future face value of the convertible debenture and the fourth quarter 2018 accrued interest of \$0.84 million. The adjusted net debt calculation should be read in conjunction with the financial statements and the adjusted net debt is not necessarily indicative of the results that would have been attained if the convertible debenture transaction had occurred on a different date.

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, 2018 <sup>(1)</sup> (Adjusted)	December 31, 2018	December 31, 2017
Net debt	2,385	45,166	38,412
Funds flow from/(used in) operating activities	(536)	(536)	5,993
Net debt to funds flow from operating activities ratio	4.45	84.26	6.41

(1) After giving effect to the January 11, 2019 settlement of \$41.94 million convertible debentures by the issue of common shares.

As at December 31, 2018, Zargon's net debt to funds flow from operating activities ratio was 84.26, a substantial increase from 6.41 at December 31, 2017. Net debt levels increased during the year as a result of the \$3.50 million (USD) term debt financing. Most notably, funds flow from operating activities decreased significantly by 109 percent from prior year due to decreased revenues, increased royalties, a realized loss on derivatives and increased interest expense.

To manage its capital structure, the Company may adjust capital spending, issue new shares, or issue new debt.

The Company's capital management objectives, evaluation measures, definitions and targets have remained unchanged over the periods presented.

## 12. REVENUE

The company derives its revenue from contacts with customers primarily through the transfer of commodities representing the following major product types:

(\$ thousands)	2018	2017
Petroleum sales	34,490	36,250
Natural gas sales	995	2,425
Petroleum and natural gas sales	35,485	38,675

At December 31, 2018, receivables from contracts with customers, which are included in trade accounts receivable, were \$0.58 million (at December 31, 2017 – \$3.22 million).

The Company's custom fee revenues are included as an offset to operating expenses, and were \$0.80 million at December 31, 2018 (\$1.24 million as at December 31, 2017).

## 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, 2018	
	Number of Shares	Amount (\$)
Balance, as at December 31, 2017	30,801	262,231
Share awards exercised	101	–
Share-based compensation transferred from contributed surplus on exercise of share awards	–	504
Balance, as at December 31, 2018	30,902	262,735

**Common Shares**

(thousands)	December 31, 2017	
	Number of Shares	Amount (\$)
Balance, as at December 31, 2016	30,607	260,902
Share awards exercised	194	–
Share-based compensation transferred from contributed surplus on exercise of share awards	–	1,329
Balance, as at December 31, 2017	30,801	262,231

**14. SHARE-BASED PAYMENTS****Stock Option Plan**

On March 24, 2017, Zargon granted an aggregate of 1.34 million stock options to our directors, officers and certain employees at an exercise price of \$0.72 per share under the Plan. Of these, 0.32 million options were granted to our non-management directors, 0.54 million options were granted to our officers and the balance of 0.48 million stock options were granted to employees. One-third of the options vested on December 31, 2017, one-third vested on December 31, 2018 and the balance will vest on December 31, 2019. Zargon uses a fair value methodology to value the stock options. The assumptions made for the stock options include a volatility factor of 64 percent, a risk free rate of one percent and a forfeiture rate of nil.

On May 30, 2017, the 2017 stock option plan was approved by a majority of the aggregate votes casted by shareholders at the 2017 Annual and Special General Meeting.

The following table summarizes information about the Company's stock options under the Stock Option Plan:

	December 31, 2018	December 31, 2017
	Number of Stock Options (thousands)	Number of Stock Options (thousands)
Outstanding at beginning of year	1,250	–
Stock options granted	–	1,340
Stock options forfeited	(95)	(90)
Outstanding at end of year	1,155	1,250

**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 16 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, 2018		December 31, 2017	
	Number of Share Awards (thousands)		Number of Share Awards (thousands)	
Outstanding at beginning of year	363		544	
Share awards granted	16		39	
Share awards exercised	(101)		(194)	
Share awards forfeited	(10)		(26)	
Outstanding at end of year	268		363	
Share awards exercisable at end of year	72		90	

### Share-Based Compensation

The share awards for the year ended December 31, 2018 resulted in share-based compensation expense in 2018 of \$0.14 million (2017 – \$0.37 million).

Compensation expense associated with share awards granted is recognized in earnings over the vesting period with a corresponding increase in contributed surplus. The exercise of share awards 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, 2018		December 31, 2017	
	Carrying Value (\$)	Fair Value (\$)	Carrying Value (\$)	Fair Value (\$)
<b>Amortized cost:</b>				
Cash and cash equivalents	5,055	5,055	4,095	4,095
Trade and other receivables	866	866	3,888	3,888
Trade and other payables	5,989	5,989	6,362	6,362
Convertible debentures	41,421	13,627	41,461	34,496
<b>Fair value through profit and loss:</b>				
Derivative liabilities	–	–	1,151	1,151
<b>Other liabilities:</b>				
Debt (\$Cdn)	4,802	4,974	–	–

### 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 financial instruments 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, 2018, 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 may enter 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. There are no derivative agreements outstanding as at December 31, 2018.

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

Crude Oil – To partially mitigate the crude oil commodity price risk, the Company may enter into fixed price swaps to partially mitigate its exposure to the WTI NYMEX price.

- **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 debt are market rate based (variable interest rates); thus, carrying values approximating fair values.

At the December 31, 2018 debt pricing levels, the increase or decrease in net earnings for the year for each one percent change in interest rates would amount to nil (2017 – nil) before swaps as the Company no longer has floating rate debt.

- **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 \$0.24 million (2017 – \$0.21 million) increase or decrease in net earnings for the year ended December 31, 2018. 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, 2018, approximately 77 percent (December 31, 2017 – 89 percent) was owing from two companies and Zargon anticipates full collection.

The Company's allowance for doubtful accounts at December 31, 2018 was nil (December 31, 2017 – \$0.02 million). During 2018, the Company did not record an additional 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, 2018, nil million (December 31, 2017 – nil) 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 11 for a more detailed discussion.

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	5,989	–	5,989
Debt (\$Cdn) <sup>(1)</sup>	512	4,462	4,974
Interest on convertible debentures	4,201	–	4,201
Convertible debentures <sup>(2)</sup>	41,941	–	41,941

(1) Amount is the full future face value of the \$3.5 million (USD) term debt plus an original issue discount of \$0.15 million (USD) in Canadian dollars

(2) Amount is the full face value of the convertible debentures at \$41.94 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 nil (2017 – \$0.29 million) for oil.

#### **16. DERIVATIVES**

The Company is a party to certain financial instruments that have fixed the price of a portion of its oil production. 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. 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 2018 was \$1.15 million and the unrealized gain for 2017 was \$0.80 million. The realized loss on the statement of earnings/(loss) and comprehensive earnings/(loss) for 2018 was \$2.41 million and the realized loss for 2017 was \$0.38 million.

There are currently no derivative contracts outstanding.

## 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)	2018	2017
Loss before tax	(35,654)	(11,374)
Expected tax rate	27.00%	27.00%
Expected income taxes recovery	(9,627)	(3,071)
Add (deduct) income tax effect of:		
Rate adjustments – United States	–	(1,844)
Difference in tax rates of foreign subsidiary	(1)	(72)
Unrecognized portion of the deferred tax asset	9,390	2,928
Permanent differences and other	(48)	(5)
Total income tax recovery	(286)	(2,064)

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

(\$ thousands)	2018	2017
Canadian oil and natural gas property expenses	172	189
Canadian development expenses	9,554	9,981
Canadian exploration expenses	4,474	6,112
Capital cost allowance	18,057	23,735
Non-capital losses	169,554	154,221
US tax pools	970	1,347
Other	1,649	1,871
	204,430	197,456

A deferred tax asset related to the carry forward of unutilized tax losses, decommissioning expenses and deferred partnership earnings has been recorded to the extent that it is probable future taxable profits will be sufficient to utilize the deferred tax asset. On this basis, the Company has limited the recognition of a deferred tax asset as of December 31, 2018. Some or all of this unrecognized amount may be recognized in future periods against future income.

The Company has non-capital losses of \$168.52 million, which expire in varying annual amounts from 2026 to 2035, and capital losses of \$1.03 million which do not expire. The Company has non-capital losses of approximately \$9.70 million (December 31, 2017 – \$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 Company has tax allowances of approximately \$1.70 million (December 31, 2017 – \$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 movement in deferred tax balances during the years ended December 31, 2018 and 2017 are as follows:

(\$ thousands)	Balance December 31, 2017	Recognized in earnings	Recognized on Balance Sheet	Balance December 31, 2018
Property, plant and equipment and intangible assets	(23,845)	5,605	–	(18,240)
Convertible debentures	459	128	–	587
Unrealized portion of derivative assets	311	(311)	–	–
Non-capital losses	39,091	4,408	–	43,499
Asset retirement obligations	17,510	(379)	–	17,131
Share issue costs	132	(31)	–	101
Foreign exchanges	–	335	(335)	–
Other liabilities	306	6	–	312
Unrecognized portion of the deferred tax asset	(38,009)	(9,390)	–	(47,399)
Net deferred tax asset/(liability)	(4,045)	371	(335)	(4,009)

(\$ thousands)	Balance December 31, 2016	Recognized in earnings	Recognized on Balance Sheet	Balance December 31, 2017
Property, plant and equipment and intangible assets	(32,775)	8,930	–	(23,845)
Convertible debentures	299	160	–	459
Unrealized portion of derivative assets	526	(215)	–	311
Non-capital losses	41,890	(2,799)	–	39,091
Asset retirement obligations	18,942	(1,432)	–	17,510
Share issue costs	64	68	–	132
Foreign exchanges	–	(355)	355	–
Other liabilities	(300)	606	–	306
Unrecognized portion of the deferred tax asset	(35,081)	(2,928)	–	(38,009)
Net deferred tax asset/(liability)	(6,435)	2,035	355	(4,045)

#### 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)	2018	2017
Salaries, directors' fees and benefits <sup>(1)</sup>	1,206	1,513
Share-based payments <sup>(2)</sup>	101	283
	1,307	1,796

(1) Includes one-time employment costs of nil in 2018 (2017 – \$0.15 million).

(2) 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)	2018	2017
Loss for diluted net loss per share calculation	<b>(35,368)</b>	(9,310)
Weighted average number of common shares – basic	<b>30,876</b>	30,727
Dilutive impact of share right incentive plans and share award plan	–	–
Weighted average number of common shares – diluted	<b>30,876</b>	30,727

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.

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, 2018 and 2017.

## 20. CHANGE IN NON-CASH FLOW INFORMATION

The net change in working capital is comprised of:

(\$ thousands)	2018	2017
Source/(use) of cash:		
Trade and other receivables	<b>3,022</b>	(403)
Deposits and prepaid expenses	<b>91</b>	(1,072)
Investment in marketable securities	–	185
Trade and other payables	<b>(373)</b>	996
Foreign exchange and other	<b>203</b>	(373)
	<b>2,943</b>	(667)
Related to operating activities	<b>3,703</b>	(1,395)
Relating to investing activities	<b>(760)</b>	728
Related to financing activities	–	–
	<b>2,943</b>	(667)

## 21. SUPPLEMENTAL CASH FLOW INFORMATION

(\$ thousands)	2018	2017
Cash interest paid	<b>2,808</b>	2,521
Cash taxes received	–	–

## 22. SIGNIFICANT SUBSIDIARIES

The Company has the following significant wholly owned, directly or indirectly, subsidiaries which are incorporated in Canada as at December 31, 2018:

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 \$0.26 million (2017 – \$0.27 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, 2018, there was \$0.12 million (2017 – \$0.07 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)	2018		
	Canada	United States	Combined
Petroleum and natural gas sales	26,108	9,377	35,485
Segment loss	(29,926)	(80)	(30,006)
Loss before income taxes	(34,971)	(683)	(35,654)
Impairment loss on property, plant and equipment	(21,163)	–	(21,163)
Impairment loss on exploration and evaluation assets	(1,422)	(393)	(1,815)
Property, plant and equipment, net	79,128	21,521	100,649
Intangible exploration and evaluation assets	–	–	–
Total assets	85,618	22,789	108,407
Net capital expenditures	3,871	432	4,303

(\$ thousands)	2017		
	Canada	United States	Combined
Petroleum and natural gas sales	31,402	7,273	38,675
Segment loss	(5,519)	(424)	(5,943)
Loss before income taxes	(10,785)	(589)	(11,374)
Impairment loss on property, plant and equipment	(1,797)	–	(1,797)
Impairment loss on exploration and evaluation assets	(244)	–	(244)
Property, plant and equipment, net	106,197	22,711	128,908
Intangible exploration and evaluation assets	1,394	341	1,735
Total assets	121,672	18,880	140,552
Net capital expenditures	7,660	1,205	8,865

Zargon derives over 77 percent of its revenue from two 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.

A joint venture partner and royalty holder has issued a claim of \$0.90 million alleging that, as Operator, the Company has made accounting errors. The Company considers the suit to be without merit and is vigorously disputing it.

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, 2018
Less than one year	553
Between one and five years	124
	677

## 26. SUBSEQUENT EVENT

On November 21, 2018, Zargon announced the proposed transaction to settle its Convertible Debentures.

On January 10, 2019, Zargon announced that 82.64% of Debentureholders voting at the extraordinary meeting of the Debentureholders voted in favour of an extraordinary resolution pursuant to which all of the Debentures will be settled and all claims of the Debentureholders will be extinguished.

On January 11, 2019, Zargon announced that it had completed a transaction to settle its \$41.94 million principal amount of outstanding 8% convertible unsecured debentures due December 31, 2019 in exchange for Zargon common shares. Pursuant to the transaction,

all of the Debentures were settled and all claims of the Debentureholders were extinguished in exchange for an aggregate of 428.88 million common shares, including payment, in the form of common shares, of the accrued and unpaid interest owing on the Debentures from and including September 30, 2018 to but not including January 11, 2019, being the effective date of the completion of the transaction, in each case on the basis of a price of \$0.10 per common share. Immediately before the transaction, 30.93 million common shares were issued and outstanding. Following the completion of the transaction, 459.81 million common shares are issued and outstanding.

# CORPORATE INFORMATION

## BOARD OF DIRECTORS

Craig H. Hansen

*Calgary, Alberta*

Kyle D. Kitagawa <sup>(1)</sup>

*Chairman of the Board*

*Calgary, Alberta*

Glenn Koach

*Los Angeles, California*

Geoffrey C. Merritt <sup>(1)</sup>

*Calgary, Alberta*

Jim Peplinski <sup>(2)</sup>

*Calgary, Alberta*

Ron Wigham <sup>(1)(2)</sup>

*Calgary, Alberta*

Grant A. Zawalsky <sup>(2)</sup>

*Calgary, Alberta*

## OFFICERS

Craig H. Hansen

President and Chief Executive Officer

Randolph J. Doetzel

Vice President, Operations

Christopher M. Hustad

Vice President, Corporate Development

William T. Cromb

Chief Financial Officer

*(1) Audit and Reserves Committee*

*(2) Governance and Compensation Committee*

## STOCK EXCHANGE LISTING

### Toronto Stock Exchange

Common Shares

Trading Symbol: ZAR

### TRANSFER AGENT

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