

Management's Report

The financial statements of Zargon Oil & Gas Ltd. were prepared by management in accordance with accounting principles generally accepted in Canada. The financial and operating information presented in this annual report is consistent with that shown in the financial statements.

Management has designed and maintains a system of internal controls to provide reasonable assurance that all assets are safeguarded and to facilitate the preparation of financial statements for reporting purposes. 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 judgements made by management.

External auditors appointed by the shareholders have conducted an independent examination of the corporate and accounting records in order to express their opinion on the financial statements.

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



J. O. McCutcheon
Chairman



C. H. Hansen
President and Chief Executive Officer

Auditors' Report

To the Shareholders of Zargon Oil & Gas Ltd.

We have audited the balance sheets of Zargon Oil & Gas Ltd. as at December 31, 2000 and 1999 and the statements of income and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Canada. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2000 and 1999 and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in Canada.

Calgary, Canada
March 2, 2001



Chartered Accountants

Balance Sheets

As at December 31

(\$ thousand)

	2000	1999
ASSETS [note 3]		
Current		
Cash	159	116
Accounts receivable	11,483	5,165
Prepaid expenses and deposits	848	361
	<u>12,490</u>	<u>5,642</u>
Property and equipment [note 2]	<u>74,394</u>	<u>50,383</u>
	<u>86,884</u>	<u>56,025</u>
LIABILITIES		
Current		
Accounts payable and accrued liabilities	15,003	5,787
Long-term debt [note 3]	15,902	14,116
Future site restoration costs	1,606	1,265
Future income taxes	11,851	2,334
	<u>44,362</u>	<u>23,502</u>
SHAREHOLDERS' EQUITY		
Share capital [note 4]	20,667	20,742
Retained earnings	21,855	11,781
	<u>42,522</u>	<u>32,523</u>
	<u>86,884</u>	<u>56,025</u>

See accompanying notes

On behalf of the Board:



John O. McCutcheon
Director



Craig H. Hansen
Director

Statements of Income and Retained Earnings

For the years ended December 31

(\$ thousand, except for per share amounts)

	2000	1999
Income		
Oil and gas sales	53,306	24,048
Hedging loss [note 7]	(2,733)	(1,095)
Royalties (net of Alberta royalty tax credit)	(10,716)	(4,033)
	<u>39,857</u>	<u>18,920</u>
Expenses		
Production	8,615	6,120
Administration	2,189	1,463
Interest on long-term debt	1,269	592
Site restoration	720	585
Depreciation and depletion	6,801	4,750
	<u>19,594</u>	<u>13,510</u>
Income before income taxes	<u>20,263</u>	<u>5,410</u>
Income taxes [note 5]		
Future	8,713	1,046
Current	288	103
	<u>9,001</u>	<u>1,149</u>
Net income for the year	<u>11,262</u>	<u>4,261</u>
Retained earnings, beginning of year	<u>11,781</u>	<u>8,004</u>
Repurchase of common shares [note 4]	(682)	(484)
Change in accounting policy [note 1]	(506)	–
Retained earnings, end of year	<u>21,855</u>	<u>11,781</u>
Earnings per common share [note 6]		
Basic	0.78	0.29
Fully diluted	0.73	0.29

See accompanying notes

Statements of Cash Flows

For the years ended December 31

(\$ thousand, except for per share amounts)

	2000	1999
Operating activities		
Net income for the year	11,262	4,261
Add non-cash items:		
Depreciation and depletion	6,801	4,750
Site restoration	720	585
Future income taxes	8,713	1,046
Cash flow from operations	27,496	10,642
Changes in non-cash working capital	(899)	(2,221)
	<u>26,597</u>	<u>8,421</u>
Financing activities		
Long-term debt	1,786	7,937
Repurchase of common shares	(1,191)	(1,058)
Issuance of common shares	434	—
	<u>1,029</u>	<u>6,879</u>
Investing activities		
Acquisition of property and equipment	(31,254)	(17,083)
Disposal of property and equipment	740	138
Site restoration expenditures	(379)	(180)
Change in non-cash working capital	3,310	1,747
	<u>(27,583)</u>	<u>(15,378)</u>
Decrease in cash	43	(78)
Cash, beginning of year	116	194
Cash, end of year	<u>159</u>	<u>116</u>
Cash interest paid	1,237	623
Cash taxes paid	128	97
Cash flow from operations per share <small>[note 6]</small>		
Basic	1.91	0.72
Fully diluted	1.77	0.70

See accompanying notes

December 31, 2000 and 1999

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Zargon Oil & Gas Ltd. (the "Corporation") is a public company incorporated under the Business Corporations Act (Alberta) engaged in the production, development and exploration of oil and gas solely in Canada.

Property and Equipment

The Corporation follows the full cost method of accounting for its oil and gas operations whereby all costs related to the acquisition of petroleum and natural gas rights are capitalized. Such costs include land and lease acquisition costs, annual carrying charges of non-producing properties, geological and geophysical costs, and costs of drilling and equipping productive and non-productive wells. Proceeds from disposals are recorded as a reduction of the related expenditures without recognition of a gain or loss unless the disposal would result in a change of 20% or more in the depletion rate.

Depreciation and depletion of capitalized costs is computed using the unit-of-production method based on the estimated proven reserves of oil and gas determined by independent consultants. Reserves are converted to common units on the basis that ten thousand cubic feet of gas is equivalent to one barrel of oil and liquids.

The Corporation applies a ceiling test to capitalized costs to ensure that such costs do not exceed estimated future net revenues from production of proven reserves at year end market prices less future production, general and administrative, financing, site restoration, and income tax costs plus the lower of cost or estimated market value of unproved properties.

Depreciation of office equipment is provided using the declining balance method at an annual rate of 20%.

Future Site Restoration Costs

Estimated future site restoration and removal costs, net of salvage values, are provided using the unit-of-production method based on estimated proven reserves. The annual charge is accounted for as an expense and the accumulated provision is reflected as a deferred liability. Actual site restoration costs are deducted from the accumulated provision in the year incurred.

Financial Instruments

Financial instruments of the Corporation consist of cash, accounts receivable, accounts payable and accrued liabilities, and long-term debt. As at December 31, 2000 and 1999, there are no significant differences between the carrying values of these amounts and their estimated market values.

The Corporation enters into swap contracts, as described in note 7, that are designed to be effective as a hedge against changes in commodity prices and foreign exchange rates. Gains and losses on the hedging contracts are deferred and are recognized when the hedged transaction occurs.

Measurement Uncertainty

The amounts recorded for depreciation and depletion of property and equipment and for site restoration are based on estimates of reserves and future costs. By their nature, these estimates and those related to the future cash flows used to assess impairment, are subject to measurement uncertainty and the impact on the financial statements of future periods could be material.

Joint Operations

The majority of the oil and gas operations of the Corporation are conducted jointly with others and accordingly these financial statements reflect only the proportionate interests of the Corporation in such activities.

Per Share Amounts

Per share amounts are calculated using the weighted average number of common shares outstanding during the year. The fully diluted earnings per share and cash flow from operations per share calculations assumes the exercise of vested stock options outstanding.

Future Income Taxes

In accordance with the recommendations of the Canadian Institute of Chartered Accountants, the Corporation adopted the liability method of tax allocation in accounting for income taxes on a retroactive basis without restatement of individual prior periods from January 1, 2000. Under the liability method, the Corporation records future income taxes for the effect of any differences between the accounting and income tax basis of an asset or liability. Future income taxes are measured using substantially enacted income tax rates. The effect of adopting the new recommendations was to increase future income tax liability and property and equipment by \$804,000 and \$298,000 respectively and to decrease retained earnings by \$506,000 on January 1, 2000.

The deferral method of accounting for income taxes was used for the year ended December 31, 1999. Under the deferral method, the Corporation recorded deferred income taxes for the tax effect of the timing differences between taxable income and income as recorded on the financial statements.

2. PROPERTY AND EQUIPMENT

(\$ thousand)	2000		
	Cost	Accumulated Depreciation and Depletion	Net Book Value
Petroleum and natural gas rights	79,103	19,524	59,579
Production equipment and facilities	19,787	5,316	14,471
Office equipment	653	309	344
	99,543	25,149	74,394

(\$ thousand)	1999		
	Cost	Accumulated Depreciation and Depletion	Net Book Value
Petroleum and natural gas rights	54,928	14,180	40,748
Production equipment and facilities	13,256	3,946	9,310
Office equipment	547	222	325
	68,731	18,348	50,383

At December 31, 2000, petroleum and natural gas rights include \$6,698,621 (1999 – \$5,431,000) relating to undeveloped properties which have been excluded from the depletion calculation.

3. LONG-TERM DEBT

The Corporation has a revolving demand credit facility which provides for a line of credit of \$32,600,000 bearing interest at prime (December 31, 2000 – 7.5%; December 31, 1999 – 6.5%) and has pledged an assignment of accounts receivable, a first floating charge on all of the assets and a fixed charge over certain property and equipment as collateral. While the credit facilities are of a demand nature, the bank has stated that it is not their present intention to demand repayment nor do they have information that would lead them to anticipate that the loan would be demanded before January 1, 2002. Accordingly, the loan is classified as long term.

4. SHARE CAPITAL

The Corporation is authorized to issue an unlimited number of common shares and an unlimited number of first preferred and second preferred shares.

Common shares:

(thousand)	2000		1999	
	Number of Shares	Amount (\$)	Number of Shares	Amount (\$)
Shares issued				
Balance, beginning of year	14,420	20,742	13,008	16,323
Conversion of Special Warrants	-	-	1,800	4,993
Normal course issuer bid	(340)	(509)	(388)	(574)
Stock options exercised	235	434	-	-
	<u>14,315</u>	<u>20,667</u>	<u>14,420</u>	<u>20,742</u>

Normal Course Issuer Bids were filed with the Toronto Stock Exchange on June 22, 1999 and November 22, 2000 whereby the Corporation was permitted to purchase and cancel up to 970,000 of its common shares prior to June 23, 2000 and 1,150,000 of its common shares prior to November 23, 2001, respectively.

Shares purchased and cancelled under these Issuer Bids are summarized as follows:

	Number of Shares (thousand)	Average Cost \$	Aggregate of Shares Purchased (\$ thousand)	Charged to Share Capital (\$ thousand)	Charged to Retained Earnings (\$ thousand)
June 22, 1999 Issuer Bid:					
June to December, 1999	388	2.71	1,058	574	484
January to June, 2000	161	3.00	487	241	246
	<u>549</u>	<u>2.81</u>	<u>1,545</u>	<u>815</u>	<u>730</u>
November 22, 2000 Issuer Bid:					
November and December, 2000	179	3.93	704	268	436
	<u>728</u>	<u>3.09</u>	<u>2,249</u>	<u>1,083</u>	<u>1,166</u>

Stock options to acquire common shares are granted to employees and directors from time to time at exercise prices equal to the market value of the shares at the date of the grant. No compensation expense is recognized for grants under this Plan when stock or stock options are issued. Any consideration paid on exercise of stock options is credited to share capital.

The Corporation has reserved 1,245,000 shares at December 31, 2000 for issuance under the stock option plan and an additional 45,000 shares have been reserved subject to shareholder approval.

A summary of the status of the Company's stock option plans as at December 31, 2000 and 1999, and changes during the years ending on those dates is presented below:

Options

	2000		1999	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
	(thousand)	\$	(thousand)	\$
Outstanding at beginning of year	1,450	2.51	985	2.47
Granted	75	3.96	470	2.61
Exercised	(235)	1.84	–	–
Cancelled	–	–	(5)	2.83
Outstanding at end of year	<u>1,290</u>	<u>2.71</u>	<u>1,450</u>	<u>2.51</u>
Options exercisable at year end	<u>842</u>	<u>2.67</u>	<u>1,005</u>	<u>2.46</u>

The following table summarizes information about stock options outstanding at December 31, 2000:

Range of Exercise Prices (\$)	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/00	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at 12/31/00	Weighted Average Exercise Price
	(thousand)		(\$)	(thousand)	(\$)
1.55 to 1.65	113	0.3 years	1.57	113	1.57
2.14 to 2.59	209	2.0 years	2.35	209	2.35
2.60	363	3.3 years	2.60	–	–
2.90 to 3.00	400	3.0 years	2.95	370	2.95
3.05 to 3.10	130	2.0 years	3.06	130	3.06
3.90 to 4.57	75	4.0 years	3.96	20	4.05
	<u>1,290</u>		<u>2.71</u>	<u>842</u>	<u>2.67</u>

5. INCOME TAXES

Income taxes differ from the amounts which would be obtained by applying statutory income tax rates to income before income taxes as follows:

(\$ thousand)	2000	1999
Computed income taxes at approximately 45%	9,053	2,435
Add (deduct) income tax effect of:		
Non-deductible crown charges, net of Alberta royalty tax credit	3,366	1,079
Resource allowance	(3,726)	(1,377)
Non-tax base depletion (net)	5	(55)
Large corporation and capital taxes	288	103
Other	15	6
Benefit of losses not previously recognized	–	(1,042)
	<u>9,001</u>	<u>1,149</u>

As at December 31, 2000, the Corporation has exploration and developments costs, undepreciated capital costs, unamortized share issue costs and loss carry forwards available for deduction against future taxable income in aggregate of approximately \$45,923,000 (December 31, 1999 – \$41,895,000).

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The components of the Corporation's future income tax assets and liabilities are as follows:

	(\$ thousand)
Net book value of capital assets in excess of tax pools	12,703
Site restoration	(723)
Share issue costs	(79)
Attributed royalty income	(50)
Future tax liability	<u>11,851</u>

6. WEIGHTED AVERAGE NUMBER OF COMMON SHARES

(thousand)	2000	1999
Weighted average number of common shares outstanding during the year	<u>14,408</u>	14,686
Fully diluted weighted average number of common shares outstanding during the year	<u>15,699</u>	15,691

Fully diluted earnings and cash flow from operations per share reflect the dilutive effect of the exercise of the vested stock options outstanding. Earnings on the funds which would have been received had the options been exercised of \$141,768 (1999 – \$340,000), net of tax, has been imputed at a rate of 4.05% (1999 – 13.8%) per annum after taxes.

7. FINANCIAL INSTRUMENTS

The Corporation is a party to certain off-balance sheet derivative financial instruments which have fixed the price of a portion of its oil and gas production. The Corporation enters into these contracts for hedging purposes only, in order to protect a portion of its future Canadian cash flow from the volatility of crude oil and gas commodity prices.

The Corporation enters into currency contracts for hedging purposes because the price received for its products varies in close relationship to the U.S. dollar currency exchange rate.

The Corporation has outstanding contracts at December 31, 2000 and 1999 as follows:

	Volume	Average Fixed Price Range	Range of Terms
At December 31, 2000			
Oil collar	54,750 bbl	\$20.00 US Put \$23.65 US Call	Jan. 1/01 – Dec. 31/01
Oil put options	146,000 bbl	\$25.00 US Put	Jan. 1/01 – Dec. 31/01
Natural gas swaps	456,000 GJ	\$3.615 – \$5.17/GJ	Jan. 1/01 – Oct. 31/01
Gas put options	1,644,000 GJ	\$3.50 – \$5.00/GJ	Jan. 1/01 – Oct. 31/01
Currency swaps	\$180,000 US/mo.	1.5165 exch.	Jan. 1/01 – Dec. 31/01
Interest rate swap	5.35% int.	\$5,000,000 CAD	Jan. 1/01 – Apr. 30/02
At December 31, 1999			
Crude oil swaps	91,400 bbl	\$19.05 – \$20.90 US	Jan. 1/00 – Dec. 31/00
Oil collar	36,600 bbl	\$19.00 US Put \$24.70 US Call	Jan. 1/00 – Dec. 31/00
Natural gas swaps	609,000 GJ	\$2.73 – \$2.97/GJ	Jan. 1/00 – Oct. 31/00
Currency swaps	\$255,000 US/mo.	1.5165 – 1.5435exch.	Jan. 1/00 – Dec. 31/01
Interest rate swap	5.35% int.	\$5,000,000 CAD	Jan. 1/00 – Apr. 30/02

At December 31, 2000, the cost to settle the above swap transactions would have been \$1,915,000 (1999 – \$975,000). These instruments have no book values recorded in the financial statements.