

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 fulfils 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.

(Signed)

J.O. McCutcheon
Chairman

Calgary, Canada
February 27, 2002

(Signed)

C.H. Hansen
President and Chief Executive Officer

AUDITORS'
REPORT

TO THE SHAREHOLDERS OF ZARGON OIL & GAS LTD.

We have audited the consolidated balance sheets of Zargon Oil & Gas Ltd. as at December 31, 2001 and 2000 and the consolidated 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 Canadian generally accepted auditing standards. 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 consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2001 and 2000 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(Signed)

Calgary, Canada
February 27, 2002

Chartered Accountants

CONSOLIDATED
BALANCE
SHEETS

As at December 31

(\$ thousand)

| | 2001 | 2000 |
|---|----------------|--------|
| ASSETS <small>[note 4]</small> | | |
| Current | | |
| Cash | 201 | 159 |
| Accounts receivable | 7,990 | 11,483 |
| Prepaid expenses and deposits | 741 | 848 |
| | 8,932 | 12,490 |
| Property and equipment <small>[note 3]</small> | 118,994 | 74,394 |
| | 127,926 | 86,884 |
| LIABILITIES | | |
| Current | | |
| Accounts payable and accrued liabilities | 12,440 | 15,003 |
| Long-term debt <small>[note 4]</small> | 24,137 | 15,902 |
| Future site restoration costs | 3,141 | 1,606 |
| Future income taxes <small>[note 6]</small> | 18,223 | 11,851 |
| | 57,941 | 44,362 |
| Commitments <small>[note 8]</small> | | |
| SHAREHOLDERS' EQUITY | | |
| Share capital <small>[note 5]</small> | 35,066 | 20,667 |
| Retained earnings | 34,919 | 21,855 |
| | 69,985 | 42,522 |
| | 127,926 | 86,884 |

See accompanying notes

On behalf of the Board:

(Signed)

J.O. McCutcheon
Director

(Signed)

C.H. Hansen
Director

CONSOLIDATED
STATEMENTS OF
INCOME AND
RETAINED
EARNINGS

For the years ended December 31

(\$ thousand, except per share amounts)

| | 2001 | 2000 |
|---|-----------------|----------|
| Income | | |
| Oil and gas sales | 63,795 | 53,306 |
| Hedging loss [note 8] | (573) | (2,733) |
| Royalties (net of Alberta Royalty Tax Credit) | (14,222) | (10,716) |
| | 49,000 | 39,857 |
| Expenses | | |
| Production | 11,933 | 8,615 |
| Administration | 3,083 | 2,189 |
| Interest on long-term debt | 957 | 1,269 |
| Foreign exchange | 107 | - |
| Site restoration | 1,045 | 720 |
| Depreciation and depletion | 10,576 | 6,801 |
| | 27,701 | 19,594 |
| Income before income taxes | 21,299 | 20,263 |
| Income taxes [note 6] | | |
| Future | 7,806 | 8,713 |
| Current | 358 | 288 |
| | 8,164 | 9,001 |
| Net income for the year | 13,135 | 11,262 |
| Retained earnings, beginning of year | 21,855 | 11,781 |
| Repurchase of common shares [note 5] | (71) | (682) |
| Change in accounting policy [note 1] | - | (506) |
| Retained earnings, end of year | 34,919 | 21,855 |
| Earnings per common share [note 7] | | |
| Basic | 0.84 | 0.78 |
| Diluted [note 1] | 0.82 | 0.76 |

See accompanying notes

CONSOLIDATED
STATEMENTS OF
CASH FLOWS

For the years ended December 31

(\$ thousand, except per share amounts)

| | 2001 | 2000 |
|---|-----------------|-----------------|
| Operating activities | | |
| Net income for the year | 13,135 | 11,262 |
| Add non-cash items: | | |
| Depreciation and depletion | 10,576 | 6,801 |
| Site restoration | 1,045 | 720 |
| Foreign exchange | 107 | - |
| Future income taxes | 7,806 | 8,713 |
| Cash flow from operations | 32,669 | 27,496 |
| Change in non-cash working capital | (1,189) | (899) |
| | 31,480 | 26,597 |
| Financing activities | | |
| Long-term debt | 8,235 | 1,786 |
| Issuance of common shares | 13,992 | 434 |
| Repurchase of common shares | (105) | (1,191) |
| | 22,122 | 1,029 |
| Investing activities | | |
| Acquisition of property and equipment | (36,014) | (31,254) |
| Disposal of property and equipment | 4,230 | 740 |
| Acquisition of Herc Oil Corp. [note 2] | (19,831) | - |
| Site restoration expenditures | (340) | (379) |
| Change in non-cash working capital | (1,605) | 3,310 |
| | (53,560) | (27,583) |
| Increase in cash | 42 | 43 |
| Cash, beginning of year | 159 | 116 |
| Cash, end of year | 201 | 159 |
| Cash interest paid | 956 | 1,237 |
| Cash taxes paid | 218 | 128 |
| Cash flow from operations per share [note 7] | | |
| Basic | 2.10 | 1.91 |
| Diluted [note 1] | 2.03 | 1.86 |

See accompanying notes

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Zargon Oil & Gas Ltd. (the "Corporation") is a public company that trades on the Toronto Stock Exchange, is incorporated under the Business Corporations Act (Alberta) and is engaged in the exploration for and the development and production of oil and gas in Canada and the United States.

Consolidation

All subsidiaries and a partnership are directly or indirectly wholly owned and their operations are fully reflected in the consolidated financial statements.

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.

Property and Equipment

The Corporation follows the full cost method of accounting for its oil and gas operations in accordance with the guideline issued by the Canadian Institute of Chartered Accountants whereby all costs relating to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized. Such costs include land acquisition costs, annual carrying charges of non-producing properties, geological and geophysical costs, and costs of drilling and equipping both productive and non-productive wells. General and administrative costs related to these activities are not capitalized.

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 on an annual basis to ensure that such costs do not exceed the estimated undiscounted future net revenues from production of gross proven reserves using year end market prices, plus the cost of undeveloped properties, net of impairment, less amounts associated with future production costs, general and administrative, financing, site restoration, and income tax costs.

Proceeds on the disposal of petroleum and natural gas properties are applied against capitalized costs, with gains or losses not ordinarily recognized, unless such a disposal would result in a change in the depletion rate of 20% or more.

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

Future Site Restoration and Abandonment Costs

Estimated future site restoration and abandonment costs, including the removal of production facilities at the end of their useful lives, and net of salvage values, are provided for using the unit-of-production method. This estimate is based on current costs, existing legislation and industry standards. 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, 2001 and 2000, 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 8, 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.

Income Taxes

The Corporation follows the liability method of tax allocation in accounting for income taxes. Under this 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 (temporary differences). Future income tax assets and liabilities are measured using income tax rates expected to apply in the years in which temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in net income in the period in which the change is substantially enacted.

The Corporation retroactively, without restatement of prior periods, adopted the liability method on January 1, 2000. At December 31, 2000 the effect of this 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.

Foreign Currency Translation

The Corporation uses the temporal method of foreign currency translation whereby the monetary assets and liabilities recorded in a foreign currency are translated into Canadian dollars at year end exchange rates and non-monetary assets and liabilities at the exchange rates prevailing when the assets were acquired or liability incurred. Revenues and expenses are translated at the average rate of exchange for the year. Gains and losses on translation are included in the consolidated statement of income.

Stock Options

The Corporation has a stock option plan available to employees and directors with grants under the Plan approved from time to time by the Board of Directors. Under the Plan, the Corporation is authorized to issue options to purchase, in aggregate, up to 10% of the issued and outstanding common shares. The options vest after one year, expire not more than five years from the date of grant, and each option can be exercised for one common share of the Corporation.

Earnings Per Common Share

In accordance with the recommendations of the Canadian Institute of Chartered Accountants, the Corporation retroactively adopted the treasury stock method for the computation and disclosure of diluted per share amounts effective January 1, 2001. Under this method, the diluted weighted average number of common shares is calculated assuming the proceeds from the exercise of dilutive options are used to purchase common shares at the average market price.

If the imputed interest method had been used for the year ended December 31, 2001, fully diluted earnings per common share would have been \$0.83 (2000 – \$0.73) and fully diluted funds from operations per common share would have been \$2.06 (2000 – \$1.77).

Measurement Uncertainty

The amounts recorded for depreciation and depletion of property and equipment and the provision for future site restoration are based on estimates. The ceiling test calculation is based on estimates of proven reserves production rates, oil and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements of changes in such estimates in future periods could be material.

2. ACQUISITION

On July 10, 2001, the Corporation acquired all of the outstanding shares of Herc Oil Corp. ("Herc"), a private oil and gas company, for cash consideration of \$19.83 million. The acquisition was accounted for by the purchase method and the purchase price has been allocated as follows:

| | |
|-------------------------|---------------|
| (\$ thousand) | |
| Working capital | 1,972 |
| Property and equipment | 23,392 |
| Future tax asset | 993 |
| Long-term debt | (5,696) |
| Future-site restoration | (830) |
| Cash consideration | <u>19,831</u> |

3. PROPERTY AND EQUIPMENT

| (\$ thousand) | 2001 | | |
|-------------------------------------|----------------|--|-------------------|
| | Cost | Accumulated Depreciation and Depletion | Net Book Value |
| Petroleum and natural gas rights | 128,066 | 27,990 | 100,076 |
| Production equipment and facilities | 25,914 | 7,362 | 18,552 |
| Office equipment | 739 | 373 | 366 |
| | <u>154,719</u> | <u>35,725</u> | <u>118,994</u> |

| (\$ 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 |
| | <u>99,543</u> | <u>25,149</u> | <u>74,394</u> |

At December 31, 2001, petroleum and natural gas rights include \$9,437,099 (2000 – \$6,698,621) relating to undeveloped properties which have been excluded from the depletion calculation.

4. LONG-TERM DEBT

The Corporation has a revolving demand credit facility which provides for a line of credit of \$50,000,000 bearing interest at prime (December 31, 2001 – 4%; 2000 – 7.5%) and has pledged an assignment of accounts receivable, a first floating charge on all of the Canadian assets and a fixed charge over certain property and equipment as collateral. As at December 31, 2001 \$22,530,000 (2000 – \$15,475,000) was drawn on this credit facility.

The Corporation also has a revolving demand credit facility in the United States for \$4,300,000 (U.S.) bearing interest at U.S. prime plus $\frac{3}{4}\%$ (December 31, 2001 – 5.5%) and has pledged a first floating charge on all of the U.S. assets and a fixed charge over certain U.S. property and equipment as collateral. As at December 31, 2001, \$725,668 (U.S.) was drawn on this facility.

While the credit facilities are of a demand nature, the banks have stated that it is not their present intention to demand repayment nor do they have information that would lead them to anticipate that the loans would be called before January 1, 2003. Accordingly, the loans are classified as long-term.

5. 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) | 2001 | | 2000 | |
|----------------------------|------------------|-----------|------------------|-----------|
| | Number of Shares | Amount \$ | Number of Shares | Amount \$ |
| Shares issued | | | | |
| Balance, beginning of year | 14,315 | 20,667 | 14,420 | 20,742 |
| Issuance of common shares | 2,000 | 13,547 | – | – |
| Normal course issuer bid | (23) | (34) | (340) | (509) |
| Stock options exercised | 374 | 886 | 235 | 434 |
| Balance, end of year | 16,666 | 35,066 | 14,315 | 20,667 |

On August 20, 2001 the Corporation issued 2,000,000 common shares for gross proceeds of \$14,100,000. Share issue costs of \$993,916 have been recorded net of tax of \$441,163.

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:

| | Average Number of Shares (thousand) | Cost Per Share \$ | Aggregate Cost 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 |
| | 549 | 2.81 | 1,545 | 815 | 730 |
| November 22, 2000 Issuer Bid: | | | | | |
| November and December, 2000 | 179 | 3.93 | 704 | 268 | 436 |
| January to March, 2001 | 23 | 4.57 | 105 | 34 | 71 |
| | 202 | 3.99 | 809 | 302 | 507 |
| | 751 | 3.13 | 2,354 | 1,117 | 1,237 |

Stock options

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 1,260,000 shares at December 31, 2001 (December 31, 2000 – 1,245,000) for issuance under the stock option plan.

A summary of the status of the Corporation's stock option plans as at December 31, 2001 and 2000, and changes during the years ended on those dates is presented below:

| | 2001 | | 2000 | |
|----------------------------------|----------------------|---|----------------------|---|
| | Shares (thousand) | Weighted Average Exercise Price \$ | Shares (thousand) | Weighted Average Exercise Price \$ |
| Outstanding at beginning of year | 1,290 | 2.71 | 1,450 | 2.51 |
| Granted | 298 | 4.94 | 75 | 3.96 |
| Exercised | (374) | 2.37 | (235) | 1.84 |
| Cancelled | (15) | 4.28 | – | – |
| Outstanding at end of year | 1,199 | 3.36 | 1,290 | 2.71 |
| Options exercisable at year end | 916 | 2.85 | 842 | 2.67 |

The following table summarizes information about stock options outstanding at December 31, 2001:

| Range of Exercise Prices (\$) | Options Outstanding | | | Options Exercisable | |
|----------------------------------|--|---|---|--|---|
| | Number Outstanding at 12/31/01 (thousand) | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price \$ | Number Exercisable at 12/31/01 (thousand) | Weighted Average Exercise Price \$ |
| 2.14 to 2.59 | 84 | 0.7 years | 2.35 | 84 | 2.35 |
| 2.60 | 338 | 2.3 years | 2.60 | 338 | 2.60 |
| 2.90 to 3.10 | 438 | 1.0 years | 3.00 | 438 | 3.00 |
| 3.90 to 4.57 | 194 | 4.0 years | 4.19 | 56 | 3.98 |
| 5.40 to 7.20 | 145 | 4.3 years | 5.65 | – | – |
| | 1,199 | | 3.36 | 916 | 2.85 |

6. 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) | 2001 | 2000 |
|---|----------------|---------|
| Statutory income tax rate | 43.33% | 44.99% |
| Computed income taxes | 9,229 | 9,053 |
| Add (deduct) income tax effect of: | | |
| Non-deductible crown charges, net of Alberta Royalty Tax Credit | 3,756 | 3,366 |
| Resource allowance | (4,394) | (3,726) |
| Rate adjustment | (440) | 5 |
| Large corporation and capital taxes | 358 | 288 |
| Other | (345) | 15 |
| | 8,164 | 9,001 |

As at December 31, 2001, the Corporation has exploration and developments costs, unamortized oil and gas property expenditures, undepreciated capital costs, unamortized share issue costs and non-capital loss carry forwards available for deduction against future taxable income in aggregate of approximately \$72,591,000 (December 31, 2000 – \$45,923,000).

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 liability are as follows:

| (\$ thousand) | 2001 | 2000 |
|---|----------------|--------|
| Net book value of capital assets in excess of tax pools | 21,140 | 12,703 |
| Site restoration | (1,359) | (723) |
| Non-capital loss carryforwards | (1,136) | - |
| Share issue costs | (379) | (79) |
| Attributed royalty income | (43) | (50) |
| | 18,223 | 11,851 |

7. WEIGHTED AVERAGE NUMBER OF COMMON SHARES

| (thousand) | 2001 | 2000 |
|--|---------------|--------|
| Weighted average number of common shares outstanding during the year | 15,558 | 14,408 |
| Diluted weighted average number of common shares outstanding during the year | 16,114 | 14,771 |

Diluted earnings and cash flow from operations per share reflect the dilutive effect of the exercise of the vested stock options outstanding.

8. 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 enters into interest rate swaps in order to fix the rate of a portion of its long term debt.

The Corporation has outstanding contracts at December 31, 2001 and 2000 as follows:

| | Volume | Average Fixed Price Range | Range of Terms |
|-----------------------------|------------------|---|------------------------|
| At December 31, 2001 | | | |
| Oil collar | 109,500 bbl | \$23.00 US/bbl Put \$28.15 US/bbl Call | Jan. 1/02 – Dec. 31/02 |
| Oil swap | 73,000 bbl | \$25.85US/bbl | Jan. 1/02 – Dec. 31/02 |
| Natural gas swaps | 856,000 gj | \$3.48 – \$4.11/gj | Apr. 1/02 – Oct. 31/02 |
| | 608,000 gj | \$3.65 – \$3.77/gj | Jan. 1/02 – Oct. 31/02 |
| Gas collars | 604,000 gj | \$5.00/gj Put \$7.05 – \$9.15/gj Call | Jan. 1/02 – Mar. 31/02 |
| Interest rate swap | 5.35% int. | \$5,000,000 CDN | Jan. 1/02 – Apr. 30/02 |
| At December 31, 2000 | | | |
| Oil collar | 54,750 bbl | \$20.00 US/bbl Put \$23.65 US/bbl Call | Jan. 1/01 – Dec. 31/01 |
| Oil put options | 146,000 bbl | \$25.00 US/bbl 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 CDN | Jan. 1/01 – Apr. 30/02 |

At December 31, 2001, \$1,447,000 would have been received to settle the above swap transactions and as at December 31, 2000, the cost to settle the swaps would have been \$1,915,000. These instruments have no book values recorded in the financial statements.

9. SEGMENTED INFORMATION

Oil and Gas Sales

| (\$ thousand) | 2001 | 2000 |
|---------------|---------------|---------------|
| Canada | 60,999 | 53,306 |
| United States | 2,796 | – |
| | 63,795 | 53,306 |

Total Assets

| (\$ thousand) | 2001 | 2000 |
|---------------|----------------|---------------|
| Canada | 123,262 | 86,884 |
| United States | 4,664 | – |
| | 127,926 | 86,884 |