

**WesternZagros Resources Ltd.****Q2 2011**

Second Quarter Interim Report  
for the periods ended June 30, 2011

**Message to Shareholders**

WesternZagros Resources Ltd. (TSX-V – WZR) ("WesternZagros" or "the Company") provides its results for the periods ended June 30, 2011, key highlights, and activities to date. The Company has also had two significant announcements since the end of the second quarter.

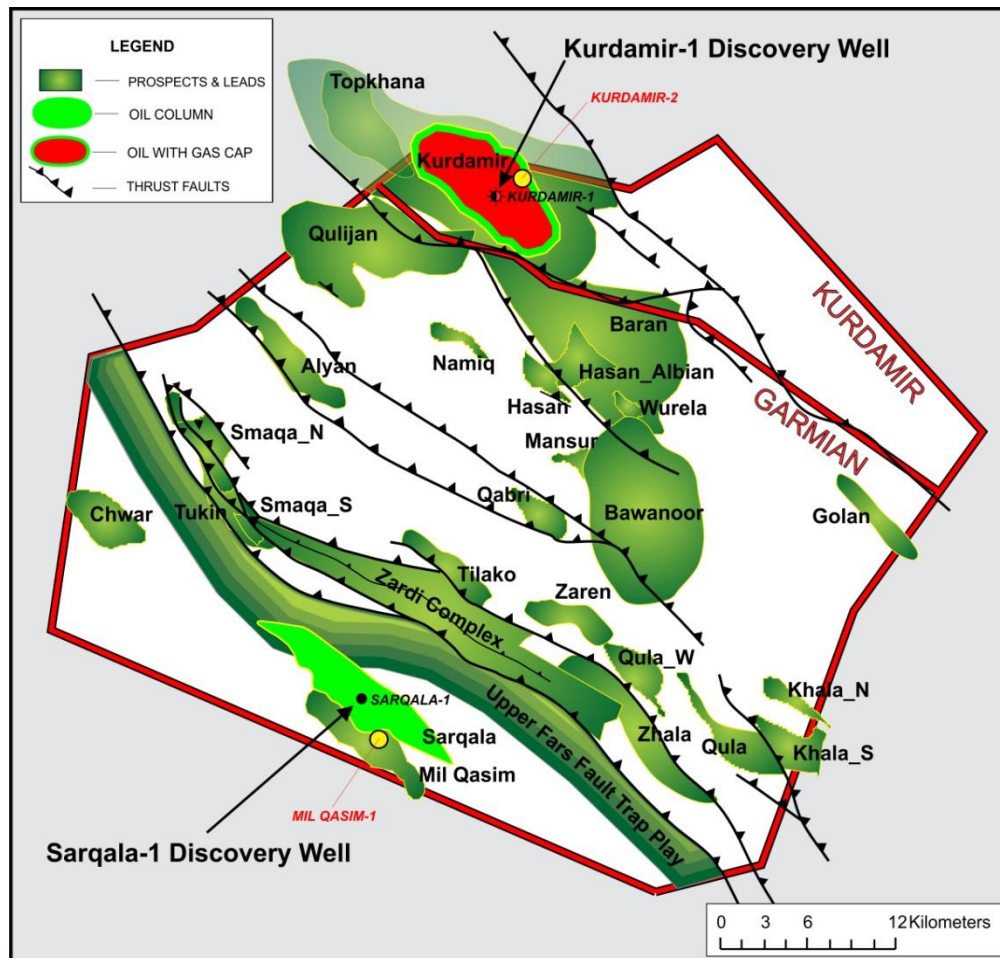
On May 31, 2011, WesternZagros made a significant oil discovery in the Jeribe Formation at the Sarqala-1 exploration well that tested at rates up to 9,444 barrels per day of 40 degree API oil. The Company is now evaluating and sourcing surface equipment and trucking facilities with the objective of producing oil by the end of 2011 through an extended well testing program.

On August 2, 2011, WesternZagros announced it had finalized an agreement with the Kurdistan Regional Government of Iraq ("KRG") and Talisman (Block K44) B.V. ("Talisman") to amend the original Production Sharing Contract ("Original PSC") that governed the Company's exploration activities in the Kalar-Bawanoor Block in Kurdistan. The agreement divides the contract area of the Original PSC into two new contract areas named Garmian and Kurdamir, each of which is now governed by a distinct PSC. WesternZagros will continue to operate the southern contract area named Garmian Block that covers approximately 1,780 square kilometres and is now governed by a new PSC ("Garmian PSC"). The Garmian Block contains the Sarqala-1 oil discovery, the Mil Qasim-1 prospect, and the other numerous prospects and plays that contributed to a large increase in prospective resources reported by the Company on July 20, 2011. The northern contract area is named Kurdamir Block. It covers some 340 square kilometres, contains the Kurdamir-1 oil, gas and condensate discovery, and is now governed by an amended version of the Original PSC ("Kurdamir PSC"). The Kurdamir Block is now operated by Talisman. WesternZagros's production sharing terms, under both the Garmian and Kurdamir PSCs, remain unchanged from the Original PSC.

On July 20, 2011, WesternZagros reported an increase of over 100 percent in the combined mean estimate of gross unrisks prospective resources on the Company's Kurdamir and Garmian exploration blocks ("PSC Lands"). The updated estimate is approximately 2.2 billion barrels of oil or 3.6 billion barrels of oil equivalent (when oil, gas and condensate prospective resources are included). Previously these estimates were 1.1 billion barrels of oil or 1.8 billion barrels of oil equivalent. This updated mean estimate has been independently audited by Sproule International Limited ("Sproule") and incorporates the multiple reservoirs in additional prospective areas of the Company's PSC Lands which are all located on the Garmian Block. The audit included prospects with Jeribe, Mio-Oligocene, Eocene and Shiranish reservoir sequences and two Upper Fars plays. These prospects and plays are potential follow-on exploration targets for future drilling consideration.

Commenting on the second quarter results and subsequent events, WesternZagros's Chief Executive Officer Simon Hatfield said, "We are very pleased by the achievements of the last few months, including our first oil discovery, a major jump in our resource estimates, and most recently, the PSC amendments. Our primary focus now is the aggressive pursuit of oil production from the Sarqala-1 well, with preparations underway for the extended well testing program, and proving up our prospective resources via the Mil Qasim-1 and Kurdamir-2 wells. We look forward to the test results of the Oligocene reservoir in Talisman's adjacent Topkhana-1 well to assist in our drilling plans for Kurdamir-2."

Figure 1. A map displaying the Original PSC block, the locations of the new Garmian and Kurdamir blocks, the hydrocarbon discoveries to date and the numerous prospects and leads within the two blocks



## Management’s Discussion and Analysis

The following management’s discussion and analysis (“MD&A”) reviews WesternZagros Resources Ltd.’s (“WesternZagros” or the “Company”) financial condition, activities and results of operations for the three and six month periods ended June 30, 2011. It should be read in conjunction with the unaudited condensed consolidated interim financial statements prepared under International Financial Reporting Standards for the period ended June 30, 2011, and the audited consolidated financial statements for the year ended December 31, 2010 prepared under Canadian Generally Accepted Accounting Principles (“GAAP”) and the related notes. The effective date of this MD&A is August 11, 2011.

## Forward-Looking Information

This discussion offers management’s analysis of the financial and operating results of WesternZagros and contains certain forward-looking statements relating to, but not limited to, operational information, future drilling plans and testing programs and the timing associated therewith, future production and sales, estimated commitments under the Company’s amended Production Sharing Contract for the Kurdamir area (“Kurdamir PSC”) and new Production Sharing Contract for the Garmian area (“Garmian PSC”), anticipated capital and operating budgets,

anticipated working capital and estimated costs. Forward-looking information typically contains statements with words such as "anticipate", "estimate", "expect", "potential", "could", or similar words suggesting future outcomes. The Company cautions readers and prospective investors in the Company's securities to not place undue reliance on forward-looking information as, by its nature, it is based on current expectations regarding future events that involve a number of assumptions, inherent risks and uncertainties, which could cause actual results to differ materially from those anticipated by WesternZagros. Readers are also cautioned that disclosed test rates may not be indicative of ultimate production levels.

Forward looking information is not based on historical facts but rather on management's current expectations and assumptions regarding, among other things, outcomes of future well operations, plans for and results of extended well tests and drilling activity, future capital and other expenditures (including the amount, nature and sources of funding thereof), future economic conditions, future currency and exchange rates, continued political stability, timely receipt of any necessary government or regulatory approvals, the Company's continued ability to employ qualified staff and to obtain equipment in a timely and cost efficient manner, the participation of the Company's co-venture partners in exploration activities, and the timing of and costs reimbursed by the third party participant interest assignment in the Garmian PSC. In addition, budgets are based upon WesternZagros's current exploration plans and anticipated costs, both of which are subject to change based on, among other things, the actual outcomes of well operations and the results of drilling and testing activity, unexpected delays, availability of future financing and changes in market conditions. Although the Company believes the expectations and assumptions reflected in such forward-looking information are reasonable, they may prove to be incorrect. Forward-looking information involves significant known and unknown risks and uncertainties. A number of factors could cause actual results to differ materially from those anticipated by WesternZagros including, but not limited to, risks associated with the oil and gas industry (e.g. operational risks in exploration; inherent uncertainties in interpreting geological data; changes in plans with respect to exploration or capital expenditures; interruptions in operations together with any associated insurance proceedings; denial of any portion of the insurance claims; the uncertainty of estimates and projections in relation to costs and expenses and health, safety and environmental risks), the risk of commodity price and foreign exchange rate fluctuations, the uncertainty associated with negotiating with foreign governments, and risk associated with international activity.

In addition, statements relating to "resources" contained herein are deemed to be forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions that the resources described can be economically produced in the future. Terms related to resource classifications referred to herein are based on the definitions and guidelines in the Canadian Oil and Gas Evaluation Handbook which are as follows. "Prospective resources" are those quantities of petroleum estimated, as of a given date, to be potentially recoverable from undiscovered accumulations by application of future development projects. Prospective resources have both an associated chance of discovery (geological chance of success) and a chance of development (economic, regulatory, market, facility, corporate commitment or political risks). The chance of commerciality is the product of these two risk components. The estimates referred to herein have not been risked for either the chance of discovery or the chance of development. There is no certainty that any portion of the prospective resources will be discovered. If a discovery is made, there is no certainty that it will be developed or, if it is developed, there is no certainty as to the timing of such development or that it will be commercially viable to produce any portion of the prospective resources. All resource estimates presented are gross volumes for the indicated reservoirs, without any adjustment for working interest or encumbrances. A barrel of oil equivalent (BOE) is determined by converting a volume of natural gas to barrels using the ratio of 6 million cubic feet (Mcf) to one barrel. BOEs may be misleading, particularly if used in isolation. A BOE conversion ratio of 6 Mcf:1 BOE is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. The Company's material change reports filed on SEDAR at [www.sedar.com](http://www.sedar.com) and dated December 16, 2010, January 17, 2011, February 22, 2011, and July 20, 2011, contain additional detail on the information used in the resource assessments and include the risks and level of uncertainty associated with the recovery and development of the resources, and the significant positive and negative factors relevant to the estimates.

Readers are cautioned that the foregoing list of important factors is not exhaustive. The forward-looking statements contained in this MD&A are made as of the date of this MD&A and, except as required by law, WesternZagros does not undertake any obligation to update publicly or to revise any of the included forward-looking statements, whether as a result of new information, future events or otherwise. The forward-looking statements contained in this MD&A are expressly qualified by this cautionary statement. See the Risk Factors

section of this MD&A for a further description of these risks and uncertainties facing WesternZagros. Additional information relating to WesternZagros is also available on SEDAR at [www.sedar.com](http://www.sedar.com), including the Company's Annual Information Form.

## **Overview**

WesternZagros is a publicly-traded, Calgary-based, international oil and gas company engaged in acquiring properties and exploring for, developing and producing crude oil and natural gas in Iraq. WesternZagros holds two Production Sharing Contracts ("PSCs") with the Kurdistan Regional Government ("KRG") in the Kurdistan Region of Iraq that are both on trend with, and adjacent to, a number of prolific historic oil and gas discoveries. Each PSC governs a separate contract area. The northern contract area (comprising some 340 square kilometres) is governed by the Kurdamir PSC which is an amended version of the original February 28, 2008 PSC that governed all of the Kalar-Bawanoor Block (the "Original PSC") and is now called the Kurdamir Block. The southern contract area (comprising some 1,780 square kilometres) is governed under the new Garmian PSC and is named the Garmian Block. WesternZagros holds a 40 percent working interest in both the Kurdamir and Garmian PSCs. The KRG holds a 20 percent working interest in both PSCs. The remaining 40 percent working interest (the third party participation interest or "TPPI") of the Kurdamir PSC is held by a wholly-owned subsidiary of Talisman Energy Inc. ("Talisman"). The remaining 40 percent TPPI of the Garmian PSC is held by the KRG and it is to be assigned to a third party participant.

## **Basis of Presentation**

### **Reporting and Functional Currency**

The Company has prepared its June 30, 2011 unaudited Condensed Consolidated Interim Financial Statements in accordance with International Financial Reporting Standards ("IFRS"). December 31, 2011 will mark the Company's first annual reporting date under IFRS. Accordingly, the comparative information for 2010, including that utilized in this MD&A, has been prepared in accordance with the Company's IFRS accounting policies. Please refer to "Adoption of IFRS" section of this MD&A for further descriptions of this impact.

The reporting and functional currency of the Company is the United States ("U.S.") dollar. All references herein to US\$ or to \$ are to United States dollars and references herein to Cdn\$ are to Canadian dollars.

## **Highlights**

WesternZagros is currently exploring for crude oil and natural gas in the Kurdistan Region of Iraq. The Company is not yet at the stage of having reserves and production, hence revenue is currently comprised entirely of interest earned on cash and cash equivalent balances and short-term investments. WesternZagros's highlights and activities for the second quarter of 2011 and to August 11, 2011 include the following.

## **HSE&S**

- Awareness and implementation of best practices with respect to health, safety, environment and security ("HSE&S") continues to be a high priority commitment of the Board of Directors, Executive Management, employees and contractors towards all of the local residents and the staff and contractors involved in the Company's operations.
- WesternZagros prides itself on the credible standards it has established as an operational benchmark. The new contractor drilling the Mil Qasim-1 well has demonstrated their commitment to the Company's high standards by their acceptance and participation in our procedures and programs. This has the positive safety result of no recordable injuries to date.
- WesternZagros has achieved a total of 289 days without any Lost Time Incidents ("LTIs") to August 11, 2011.

## Operations

- The Company re-entered the Sarqala-1 well bore on March 29, 2011, and made a significant oil discovery after drilling an approximate 100 metre long sidetrack to a depth of 3,893 metres. Hydrocarbon shows and log results indicated a potential gross pay interval of over 55 metres in this zone. The Jeribe Formation flowed light (40 degree API) oil at a stabilized rate of 6,000 barrels per day over the 24 hours of the initial flow period. This rate was achieved through a 36/64 inch choke at a flowing well head pressure of 3,900 psi and without any stimulation of the reservoir. No water was produced during this flow. The Company then tested the well and achieved rates up to 9,444 barrels per day of 40 degree API oil. This rate was reached after flowing and stabilizing the well at progressively bigger choke sizes until limited by the flow capacity of surface equipment. The final rate was achieved on a 52/64 inch choke with a wellhead pressure of 2,475 psi. No water was produced during this initial testing program. No stimulation was applied to the well although there remains the potential to do so at a later date. On June 7, 2011 the Company successfully completed the initial testing phase of this oil discovery.
- Preparations are currently underway for WesternZagros to drill the Mil Qasim-1 well, with an anticipated spud date in mid August 2011. The 2,000 HP Viking Drilling Rig #10 is secured through a contract with Maritas Co., a subsidiary of Viking Oilfield Services of the United States, to drill the Mil Qasim-1 well.
- Site construction of the Kurdamir-2 well is approximately 50 percent complete. Kurdamir-2 is approximately two kilometres away from Kurdamir-1 and the well will target the Oligocene, Eocene and Cretaceous reservoirs. WesternZagros and Talisman have sourced the necessary long lead items, including casing and wellhead equipment and are currently preparing the drilling plan for Kurdamir-2.

## Exploration

- On July 20, 2011, Sproule International Limited (“Sproule”) completed the fourth in a series of independent audits of the Company’s resource assessments on the Kurdamir and Garmian blocks (the “PSC Lands”). The audit included prospects identified on the Garmian Block with Jeribe, Mio-Oligocene, Shiranish and Eocene reservoirs (Tilako, Zardi, Segrdan, Chwar, Alyan) and two Upper Fars plays (Fault Trap Play, Bawanoor Saddle). The combined mean estimate of gross unrisks prospective resources for these prospects is 1,099 million barrels of oil, or 1,798 million barrels of oil equivalent when gas and condensate prospective resources are included. This audit, together with the previous audit results announced on December 16, 2010, January 17, 2011, and February 22, 2011, respectively, increased the combined mean estimate of gross unrisks prospective resources on the Company’s PSC Lands to 2,192 million barrels of oil, or 3,570 million barrels of oil equivalent when gas and condensate are included.
- The Sarqala-1 Discovery Report was submitted to the KRG in the second quarter of 2011 as per the PSC’s requirements.
- WesternZagros continues to compile seismic data and information from wells adjacent to its PSC Lands to integrate with its existing large technical database and aid further in the definition and upgrade of its prospects and leads inventory. Talisman’s Topkhana-1 testing results from the Oligocene reservoir are expected in the third quarter of 2011 and from the deeper Eocene and Cretaceous reservoirs in the fourth quarter of 2011. The Topkhana well results will impact the drilling plan for the Kurdamir-2 well and the potential drilling order of the Qulijan and Baran prospects in the Garmian Block.
- The Company’s exploration work included integrating field geology work into the Company’s understanding of the Oligocene and Jeribe Formation reservoirs and detailed structural analyses of the Oligocene reservoir in the Kurdamir-1 well and the Jeribe Formation of the Sarqala-1 well sidetrack. In the second quarter of 2011 WesternZagros also completed a quantitative fluorescence study of drill cuttings from the Kurdamir-1 well to better understand the presence of oil versus gas in reservoirs to be drilled in the Kurdamir-2 well. Results indicate the probable presence of an oil column in the Lower and Middle Shiranish formations (Cretaceous), gas in the Upper Shiranish Formation, and oil in Eocene aged reservoirs. The Kurdamir-2 well is operated by Talisman, with a spud date currently expected by the end of 2011.

## Financial

- As at June 30, 2011, WesternZagros had \$46.7 million in working capital.

- For the six months ended June 30, 2011, WesternZagros's share of capital expenditures, associated with its Original PSC activities and other capitalized costs was \$33.9 million (net of disposals and prior to the impact of changes in non-cash investing capital). Year-to-date expenditures for 2011 included \$29.7 million of drilling-related costs; \$0.9 million of geological and geosciences related work; \$2.3 million of supervision and field office costs; and \$1.0 million of other PSC-related expenditures. These expenditures reflect the requirement that WesternZagros currently fund 100 percent of the Sarqala-1 sidetracking and testing costs as well as other activities on the Garmian Block.

#### **Insurance**

- WesternZagros has concluded its insurance claim for a total of \$45 million relating to the Kurdamir-1 well, the proceeds for which have all been received at the date of this MD&A. The Company and its insurers have also agreed to terms to renew its insurance policy for the drilling of the Kurdamir-2 well. These terms include an increase in the net aggregate limit from \$45 million to \$75 million.

#### **Corporate**

- WesternZagros finalized an agreement with the KRG and Talisman to amend the Original PSC that governed the Company's exploration activities in the Kalar-Bawanoor Block in Kurdistan. The agreement divides the contract area of the Original PSC into two contract areas named Garmian and Kurdamir and each is now governed by a distinct PSC.

#### **Political**

- Further improvement in Iraq's political environment was seen in the resumption of oil exports from the Kurdistan region in February 2011, and the subsequent release of the first oil export payment to the KRG from the Federal Ministry of Finance in May 2011. KRG's contractors confirmed receipt of their first payments. DNO International ASA confirmed receipt of \$103 million for their February/March production from Tawke, and TTOPCO (Genel Enerji AS and Sinopec Corp.) confirmed receipt of \$92 million for their production from Taq Taq. These payments are equal to approximately 50 percent of net revenue. Payment to KRG contractors from revenues received from the Federal Government of Iraq provides the opportunity for WesternZagros to potentially generate cash flow from an extended well test at Sarqala.
- July 2011 witnessed new entrants to the region, including Afren plc, PetroCeltic International plc, Repsol YPF, SA, and Hess Corp, purchasing interests in license blocks in the Kurdistan Region of Iraq, providing further endorsement of the international oil industry's confidence in Iraq's improving political situation.
- In July 2011, the central government's Oil and Energy Committee held parliamentary hearings to deliberate the proposed formation of a national oil company, the draft oil and gas law and the status of contracts that have been signed in the absence of a definitive legal framework. The hearings give new momentum to a legislative process that had been stalled since a draft oil law was tentatively approved in February 2007.

#### **Corporate Social Responsibility**

- WesternZagros aspires to be an industry leader with respect to corporate social responsibility. The Company and its co-venturers continue to focus on four key corporate social responsibility initiatives in the PSC Lands of Kurdistan, namely, local employment, water supply, education and health care. Activities included:
  - Drilling water wells in over 17 villages and repairing another eight wells through July 2011. Sumps, pits and irrigation channels were dug in another 42 rural communities that do not have any other reliable sources of drinking water.
  - Completing repairs to six primary schools in the Garmian region.
  - Distributing over 2,000 school supply backpacks to school children in over 30 primary schools in the Garmian region.
  - Refurbishing of the Aziz Zadr Health Clinic.
  - Purchasing and distributing sports equipment to villages in the Garmian region.

- Creating a new soccer pitch for the village of Hasira.
- Together with an international NGO, contributing towards the purchase of a youth mobile literacy bus.

### **General and Administrative Expenses**

For the three and six months ended June 30, 2011, WesternZagros expensed \$1.8 million and \$3.6 million in general and administrative expenses (“G&A”), respectively, as compared to \$1.5 million and \$3.2 million for the comparable periods in 2010. G&A costs were higher in 2011 due to the relatively stronger Canadian dollar in 2011, which impacts a large portion of the Company’s G&A expenditures, as well as increased personnel costs.

For the six months ended June 30, 2011, WesternZagros capitalized \$2.1 million of G&A (2010: \$0.9 million). The amounts capitalized are directly related to the supervision of the Company’s exploration and evaluation activities. The increase in 2011 reflects the requirement that WesternZagros fund 100 percent of the Sarqala-1 sidetrack drilling and testing, as well as other activities on the Garmian Block, Prior to assignment of the TPPI by the KRG.

### **Depreciation, Depletion and Amortization (DD&A)**

For the three and six months ended June 30, 2011, WesternZagros had \$0.05 million and \$0.1 million, respectively, of depreciation related to certain administrative assets (2010: \$0.1 and \$0.3 million). No depletion of exploration and evaluation expenditures will be recognized until such time that the technical feasibility and commercial viability of reserves have been demonstrated and the development of those reserves has been sanctioned, in which case the assets would then be reclassified as development expenditures, tested for impairment, and depleted on a unit of production basis.

### **Share based payments**

The Company recognized the expense associated with share based payments on a graded vesting basis for all stock options granted. For the quarter ended June 30, 2011, WesternZagros recorded \$0.2 million in stock based compensation expense (2010: \$0.2 million) and \$0.2 million as part of capitalized G&A (2010: negligible), with a corresponding increase to contributed surplus. For the six months ended June 30, 2011, WesternZagros recorded \$0.4 million in stock-based compensation expense (2010: \$0.5 million), and \$0.3 million as part of capitalized G&A (2010: negligible).

### **Foreign Exchange**

WesternZagros adopted the U.S. dollar as its measurement and reporting currency since the majority of its expenditures are, or will be, directly or indirectly denominated in U.S. dollars and to facilitate a more direct comparison to other international crude oil and natural gas exploration and development companies. As at June 30, 2011, WesternZagros held approximately 85 percent of its cash and cash equivalents in U.S. dollar accounts and U.S. dollar overnight term deposits. The Company also has certain assets and liabilities in currencies other than the U.S. dollar (mainly Canadian dollars). For financial statement presentation purposes, WesternZagros converts other currencies to U.S. dollars at the end of each period resulting in foreign exchange gains and losses. Canadian dollar balances are held for the purpose of funding WesternZagros’s Canadian dollar expenditures, which are mainly related to the costs associated with general and administrative costs for its head office and certain drilling-related services and tangible equipment procured from Canadian suppliers. For the quarter ended June 30, 2011, WesternZagros recorded a foreign exchange gain of \$0.1 million relating to these conversions, compared to a \$0.2 million foreign exchange loss for the quarter ended June 30, 2010. For the six months ended June 30, 2011, WesternZagros recorded a foreign exchange loss of \$0.1 million, compared to a \$0.2 million loss for the six months ended June 30, 2010.

## **Income Taxes**

For the quarter ended June 30, 2011, WesternZagros had a net income tax recovery of \$0.4 million (2010: \$0.1 million recovery), comprised of \$0.5 million of current income tax recovery (2010: \$0.2 million recovery) and a \$0.1 million deferred income tax expense (2010: \$0.1 million expense). For the six months ended June 30, 2011, WesternZagros had a net income tax recovery of \$0.9 million (2010: \$0.8 million) comprised entirely of current income tax recovery (2010: \$0.9 million current income tax recovery and \$0.1 million deferred tax expense). The current tax recovery relates to the expected recovery of taxes incurred in 2008 on realized foreign exchange gains and losses in WesternZagros's wholly-owned Canadian subsidiary through the utilization of share issuance costs as well as the associated G&A costs incurred by the subsidiary.

## **Revenue**

WesternZagros's revenue is comprised entirely of interest earned on cash and cash equivalents and short-term investment balances. Interest of \$0.03 million was earned for the quarter ended June 30, 2011 compared to \$0.02 million for the quarter ended June 30, 2010. Interest of \$0.05 million was earned for the six months ended June 30, 2011, compared to \$0.04 million for the six months ended June 30, 2010.

## **Net Loss**

For the quarter ended June 30, 2011, WesternZagros recorded a net loss of \$1.4 million compared to \$1.6 million for the quarter ended June 30, 2010. For the six months ended June 30, 2011, WesternZagros recorded a net loss of \$2.9 million (2010: \$3.0 million loss). WesternZagros is an early stage exploration enterprise and, apart from its working interest in the Kurdamir and Garmian PSCs and cash and cash equivalents, the Company has no other significant assets. The increase in G&A costs for the first six months of 2011 was offset by lower depreciation and lower foreign exchange losses as compared to the same period of 2010.

## **Capital Expenditures**

For the three months ended June 30, 2011, WesternZagros's share of capital expenditures associated with its activities and other capitalized costs was \$18.4 million (prior to the impact of changes in non-cash investing capital). Expenditures for the second quarter of 2011 included \$16.6 million of drilling-related costs; \$0.6 million of geological and geosciences related work; \$0.7 million of supervision and field office costs; and \$0.5 million of other PSC related expenditures. These expenditures reflect the requirement that WesternZagros currently fund 100 percent of the Sarqala-1 sidetracking and testing costs as well as other activities on the Garmian Block.

By comparison, WesternZagros's share of exploration and evaluation expenditures for the quarter ended June 30, 2010 associated with its activities was \$16.0 million. Capital expenditures for the second quarter of 2010 included \$14.8 million of drilling-related costs; \$0.3 million of geological and geosciences-related work; \$0.7 million for related field office and supervision costs in support of operations; and \$0.2 million for other PSC-related costs.

For the six months ended June 30, 2011, WesternZagros's share of capital expenditures associated with its activities and other capitalized costs was \$33.9 million (net of disposals and prior to the impact of changes in non-cash investing capital). Expenditures included \$29.7 million of drilled-related costs; \$0.9 million of geological and geosciences related work; \$2.3 million of supervision and field office costs; and \$1.0 million of other PSC-related expenditures. These expenditures reflect the requirement that WesternZagros currently fund 100 percent of the Sarqala-1 sidetracking and testing costs as well as other activities on the Garmian Block.

By comparison, WesternZagros's share of exploration and evaluation expenditures for the six months ended June 30, 2010 associated with its activities was \$29.1 million. Expenditures included \$27.2 million of drilling-related costs; \$0.4 million of geological and geosciences work; \$1.3 million of supervision and local office costs; and \$0.2 million of other PSC-related activities.

WesternZagros capitalized \$2.1 million of G&A expenses, including \$0.3 million of stock-based compensation, for the six months ended June 30, 2011, compared to capitalizing \$0.9 million of G&A expenses, including a negligible amount of stock-based compensation, for the six months ended June 30, 2010.

### Kurdamir and Garmian Production Sharing Contracts: Summary and Commitments

Under the terms of its Kurdamir and Garmian PSCs, WesternZagros has a 40 percent working interest and the KRG has a 20 percent working interest which is carried by WesternZagros. The remaining 40 percent TPPI in the Kurdamir PSC is held by a wholly-owned subsidiary of Talisman and the remaining 40 percent TPPI in the Garmian PSC is held by the KRG to be assigned to another third party participant. WesternZagros, the KRG and Talisman for the Kurdamir PSC and WesternZagros, the KRG, and the third party participant for the Garmian PSC, are collectively the “Contractor Groups.”

A summary of the material amendments to the Original PSC and remaining commitments are set forth in Table 1.

Table 1. Material amendments to the Original PSC and WesternZagros’s remaining PSC commitments

	Original PSC (Kalar-Bawanoor)	Amended PSC (Kurdamir)	New PSC (Garmian)
First exploration sub-period (expires)	December 31, 2010	June 30, 2012	December 31, 2011
Exploration obligation (remaining)	Third exploration well	Kurdamir-2	Mil Qasim-1 exploration well
Second exploration sub-period	Additional two years	Additional two years	Additional two years
Exploration obligation	Two exploration wells	One appraisal well	One exploration well
Other extensions	Two one year extensions	Six month extension	One year extension
Work commitments		One appraisal well	One exploration well
Economic terms	10% Royalty Oil, remainder available for Cost Recovery and Profit Oil	Unchanged	Unchanged
PSC payments	\$ 5 Million Signature Bonus \$40 Million Capacity Building Support Payment \$ 1.1 Million annual payments	Additional Capacity Building Support Payment payable equal to 3% of WesternZagros Profit Oil. Continuation of previous annual payments.	Additional Capacity Building Support Payment payable equal to 3% of WesternZagros Profit Oil. Annual payments 50% of previous payments.
Operator	WesternZagros	Talisman	WesternZagros
Working interest	WesternZagros 40% Talisman 40% KRG 20% *	WesternZagros 40% Talisman 40% KRG 20% *	WesternZagros 40% Unassigned TPPI 40%** KRG 20% *
Contract area	2,120 km <sup>2</sup>	340 km <sup>2</sup>	1,780 km <sup>2</sup>

\* WesternZagros funds 20% of the KRG costs, ultimately to be recovered by WesternZagros through the KRG’s share of Cost Recovery Oil.

\*\* WesternZagros initially funds the 40% of the costs for the third party participant until the TPPI is assigned by the KRG. The amounts funded by WesternZagros for the TPPI will be repaid upon assignment of this interest.

As at June 30, 2011, the Company estimates expenditures of approximately \$70 million, prior to the costs of any testing, to meet its remaining commitments for the first exploration sub-periods under the PSCs. This estimate includes the Company’s current 100 percent funding requirement for the remaining costs associated with drilling the Mil Qasim-1 commitment well by December 31, 2011; the Company’s 60 percent funding requirement of costs for drilling the Kurdamir-2 commitment well by June 30, 2012; the associated supervision and local office support costs

related to both drilling operations; and the Company's annual funding requirements for certain technological, logistical, recruitment and training support under its PSCs.

### **Kurdamir and Garmian Production Sharing Contracts: Commercial Terms**

Under the Kurdamir and Garmian PSCs, the sharing of oil occurs as follows: of the total oil produced, operations oil is available to the Contract Group for use in carrying out its obligations under the PSCs; the remaining oil is subject to a 10 percent royalty payable to the KRG (the residual is considered to be "net available oil"). The net available oil is determined on a development by development basis. Up to 45 percent of the net available oil is available for cost recovery with the remainder as "profit oil". Costs subject to cost recovery include all costs and expenditures incurred by the Contractor Group for exploration, development, production and decommissioning operations, as well as any other costs and expenditures incurred directly or indirectly with these activities. The portion of profit oil available to the Contractor Group is based on a sliding scale from 35 percent to 16 percent depending on a calculated R-Factor. The R-Factor is established by reference to the ratio of cumulative revenues over cumulative costs. When the ratio is below one, the Contractor Group is entitled to 35 percent of the profit oil. The percentage is then reduced on a linear sliding scale to a minimum of 16 percent at an R-Factor ratio of two or greater.

The production sharing terms for natural gas are the same as the oil production sharing terms except that the net available gas available for cost recovery is 55 percent and the profit sharing component is on a different scale. For natural gas, the portion of profit natural gas available for the Contractor Group is based on a sliding scale from 40 percent to 20 percent depending on a calculated R-factor. The R-Factor is established by reference to the ratio of the Contractor Group's cumulative revenue over cumulative costs. When the R-Factor is below one, the Contractor Group is entitled to 40 percent of the profit oil. The Contractor Group's percentage is then reduced on a linear scale to a minimum of 20 percent at a ratio of 2.75 or greater.

As at June 30, 2011, the Company had approximately \$78 million relating to the Kurdamir PSC and \$116 million related to the Garmian PSC, both net to WesternZagros of recoverable costs available that may ultimately be recovered from future crude oil or natural gas sales in accordance with the PSCs.

### **Production**

The Kurdamir and Garmian PSCs provide the Contractor Group with the exclusive right to develop and produce any commercial discoveries. The development period for producing a commercial discovery is an initial term of 20 years from the date of declaring a commercial discovery with a further automatic right to a five year extension. If commercial production is possible at the end of the last period then the Contractor Group shall be entitled to an extension of a further five years under the same terms as in the Original PSC if a request is made by the Contractor Group at least six months before the end of the first five year extension.

Pursuant to the terms of the Kurdamir and Garmian PSCs, WesternZagros maintains the right to market its share of oil on the world market. There is an obligation under the Kurdamir and Garmian PSCs to make oil production available to meet regional market demand. The price of such oil is a market-based price based on a basket of crudes. The price for natural gas is based on local commercial value and Iraq tariffs. Currently, no markets exist for natural gas within Iraq and there is no infrastructure for export.

### **Other Commitments**

The Company has entered into and terminated various exploration-related contracts, including contracts for drilling equipment, services, tangibles and consulting service contracts. The following table summarizes the estimated commitments in relation to these exploration-related contracts relating to the PSCs and other contractual obligations at June 30, 2011:

	For the Years Ending December 31,					
	2011	2012	2013	2014	2015+	Total
Exploration	\$4,462	\$5,500	-	-	-	\$9,962
Office	\$326	\$579	\$599	\$456	-	\$1,960
	\$4,788	\$6,079	\$599	\$456	-	\$11,922

### Consulting Service Contracts

In 2003 the Company entered into a consulting service contract that provided for a three percent right to participate indirectly in the future profits the Company may earn in respect to the Original PSC, in exchange for consulting services provided since that date. The contract has been terminated. Further, in 2004 the Company entered into a consulting service contract that provided for a two percent right to participate indirectly in the future profits the Company may earn in respect to the Original PSC, in exchange for the provision of consulting services during the period 2004 to 2006. During the second quarter of 2011 the contract was terminated.

### Off Balance Sheet Arrangements

The Company does not presently utilize any off-balance sheet arrangements to enhance its liquidity and capital resource positions, or for any other purpose. During the period ended June 30, 2011, WesternZagros did not enter into any off-balance sheet transactions.

### Insurance Claim Update

WesternZagros initiated a control of well insurance claim in the first quarter of 2010 in relation to certain events at Kurdamir-1 which commenced when the well was drilled into a high pressure formation in the Gulneri Seal. These operations continued after a subsequent additional high pressure zone was encountered in the Aaliji Seal and continued until October 14, 2010, when the open hole in the Kurdamir-1 well was plugged and cemented to approximately 2,500 metres, concluding well control operations.

WesternZagros has concluded its insurance claim for a total of \$45 million, the proceeds of which have all been received at the date of this MD&A. The Company and its insurers have also agreed to terms to renew its insurance policy for the drilling of Kurdamir-2. These terms include an increase in the net aggregate limit from \$45 million to \$75 million.

### Outlook for 2011

In 2011 and the first half of 2012, WesternZagros plans to focus on a program of drilling and testing to evaluate the highly prospective formations discovered through the Sarqala-1 and Kurdamir-1 wells. This program will test the approximately one billion barrels of oil equivalent of mean gross unrisks prospective resources that these formations are estimated to contain as of December 14, 2010 and January 14, 2011, as audited by Sproule International Limited.

The Company began the first of these operations by re-entering the Sarqala-1 well bore testing the Jeribe reservoir at rates up to 9,444 barrels per day of 40 degree API oil. The Company is now evaluating and sourcing surface equipment and trucking facilities with the goal of producing and selling oil by the end of 2011 through an extended well testing program. The objective is to further evaluate the Jeribe reservoir while generating cash flow from operations. The Company has submitted a request to the KRG's Ministry of Natural Resources for approval to commence this extended testing program and will submit its full appraisal work program and budget to the Ministry of Natural Resources later in the third quarter of 2011.

Commencing in mid August 2011, WesternZagros plans to drill the remaining Garmian Block commitment well at Mil Qasim-1, located three kilometres from Sarqala-1. Mil Qasim-1 will target potential oil-bearing sandstones in the Upper Fars reservoir, which exhibited oil shows when penetrated in Sarqala-1. With a proposed total depth of 2,000 to 2,400 metres, Mil Qasim-1 will be a shallower well with less technical risk than either Sarqala-1 or Kurdamir-2.

Concurrent with the Company's drilling operations at Mil Qasim-1, Talisman is continuing to drill the Topkhana prospect on its adjacent Block 39, where operations commenced on January 31, 2011. Topkhana-1 is being drilled to evaluate and test the Oligocene, Eocene and Cretaceous reservoirs. Although WesternZagros has no working interest in Topkhana-1, results from the well could provide information confirming the hypothesis that the Kurdamir and Topkhana structures may both be part of one large structure. Testing results expected in the third quarter of 2011 from the Oligocene reservoir and in the fourth quarter of 2011 from the deeper Eocene and Cretaceous reservoirs in Topkhana-1 will also impact the drilling plan for the Kurdamir-2 well and the potential drilling sequence of the nearby Qulijan and Baran prospects in the Garmian Block.

Site construction of the Kurdamir-2 well is approximately 50 percent complete. Kurdamir-2 is approximately two kilometres away from Kurdamir-1 and the well will target the Oligocene, Eocene and Cretaceous Formations. WesternZagros and Talisman have sourced the necessary long lead items, including casing and wellhead equipment and are currently preparing the drilling plan for Kurdamir-2.

With the objective of maximizing its options and flexibility to increase the likelihood of success, WesternZagros's priorities for the remainder of 2011 are as follows:

- Prepare for and implement an extended well test program for the Jeribe Formation in Sarqala-1, including the trucking and sale of crude oil.
- Drill Mil Qasim-1 to test the oil potential of the Upper Fars Formation;
- Begin drilling Kurdamir-2 to test the Oligocene, Eocene and Cretaceous formations; and
- Evaluate the commercial potential of and design an appraisal program for the natural gas, gas condensate and oil discovered at Kurdamir, and evaluate the commercial potential for any discoveries from Mil Qasim-1.

WesternZagros estimates its capital and operating budget for the remaining two quarters of 2011, including the requirement for the Company to fund 100 percent of the Sarqala-1 completed extended well testing and Mil Qasim-1, until the TPPI is assigned, and to fund its share of the costs of the Kurdamir-2 well, to be approximately \$70 million. This includes approximately \$60 million for drilling and related costs with the remainder of the budget comprised of funds for certain annual Kurdamir and Garmian PSC payments, initial technical studies as part of the Kurdamir Discovery appraisal program, in-country operational support and corporate general and administrative costs.

### **Liquidity and Capital Resources**

WesternZagros is currently exploring for crude oil and natural gas in the Kurdistan Region of Iraq and currently has no reserves, production or operational cash flows. WesternZagros's revenue is comprised entirely of interest earned on cash and cash equivalent balances and short-term investments. WesternZagros invests its cash and cash equivalents with major Canadian financial institutions with investment grade credit ratings and in Government of Canada instruments. This is in accordance with an Investment Policy approved by the Board of Directors. WesternZagros had \$46.7 million in working capital and no outstanding bank debt or other interest bearing indebtedness as at June 30, 2011.

WesternZagros may be required to access further funding in 2011, in particular as it relates to the drilling of Kurdamir-2, and ultimately to fund any appraisal programs and future development programs from successful exploration activities. WesternZagros will monitor the timing and likelihood of the third party participant being

assigned by the KRG in the Garmian PSC in determining its future capital requirements, as WesternZagros will continue to fund 100 percent of the costs incurred on the Garmian Block until such a time as the TPPI is assigned by the KRG. Upon assignment of the TPPI by the KRG WesternZagros will be reimbursed for the costs that it has funded on the Garmian PSC and will be able to utilize these funds for other exploration and appraisal activities.

During the remainder of 2011, WesternZagros will also focus its efforts on the Sarqala extended well testing operations, including potential cash flow from the sale of crude oil produced from these operations under the export terms agreed to by the KRG and the Federal Government of Iraq during the first quarter of 2011. Cash flow from Sarqala-1 could then be used to fund or partially fund future exploration and appraisal activities.

WesternZagros, in considering the proper timing to access further capital, will assess the following factors:

- The required capital and timing associated with the extended well test being planned for Sarqala-1;
- The expected timing for full exploration results from Mil Qasim-1 and any preliminary results achieved while drilling;
- The ability to export oil and natural gas from the Kurdistan Region of Iraq in accordance with the economic terms under the PSC's likely following the promulgation of the new Federal Petroleum Law of Iraq; and
- The current conditions in the financial markets, including the potential for further market instability.

With the successful oil test at Sarqala-1, the commencement of payments for oil exported from the Kurdistan Region of Iraq, and general industry interest in the Kurdistan Region, management has a reasonable expectation that any future capital requirements can be met through either further equity issuances or cash flow generated from extended well tests.

### Outstanding Share Data

As at August 11, 2011, the total number of shares outstanding was 297,209,472 and 1,173,666 stock options forfeited by employees and contractors. The total stock options outstanding were 18,415,767.

### Supplemental Quarterly Information

The following table summarizes key financial information on a quarterly basis for the periods indicated, note that only the quarters for 2011 and 2010 are in accordance with accounting policies under IFRS, while the presented 2009 data is in accordance with previous GAAP:

(US\$ thousands, unless otherwise specified)	Three Month Periods Ended			
	June 30 2011	Mar 31 2011	Dec 31 2010	Sept 30 2010
Total Revenue	34	17	13	38
Net Loss	1,416	1,480	2,003	819
Net Loss Per Share (US\$ Per Share) (Basic and Fully Diluted)	0.005	0.006	0.010	0.004
Capital Expenditures, net of disposals	18,420	15,494	17,283	20,455
Total Assets	272,650	271,720	240,290	233,770
Total Non-Current Liabilities	864	816	649	665
Dividend (US\$ per Share)	Nil	Nil	Nil	Nil

	Three Month Periods Ended			
	June 30 2010	March 31 2010	Dec 31 2009	Sep 30 2009
Total Revenue	17	19	32	36
Net Loss	1,646	1,333	1,035	2,712
Net Loss Per Share (US\$ Per Share) (Basic and Fully Diluted)	0.008	0.006	0.005	0.013
Capital Expenditures	15,962	13,153	11,250	11,456
Total Assets	235,295	235,514	241,077	241,600
Total Non-Current Liabilities	624	573	175	171
Dividend (US\$ per Share)	Nil	Nil	Nil	Nil

## RISK FACTORS

The risks factors that could influence actual results have not changed since the 2010 Annual Report and Annual Information Form including the risk that WesternZagros's ability to access the equity or debt markets in the future may be affected by further drilling challenges and related increases to exploration well costs. Any financial market instability may impact WesternZagros's ability, and that of other exploration and development companies, to access equity or debt markets at all or with acceptable terms. The inability to access the equity or debt markets for sufficient capital, at acceptable terms and within required time frames, could have a material adverse effect on WesternZagros's financial condition, results of operations and prospects.

An investment in WesternZagros should be considered highly speculative due to the nature of its activities, the present stage of its development, the need for continued participation of the Company's co-venturers in the PSC activities, timing and likelihood of The Garmian third party participant interest being assigned, and the Company's need for additional financing in the future for any acquisition, exploration, development and production of oil and gas reserves beyond current funding levels. WesternZagros's risk factors include, but are not limited to, all the risks normally incidental to the exploration, development and operation of crude oil and natural gas properties and the drilling of crude oil and natural gas wells, including geological risk, encountering unexpected formations or pressures, potential environment damage, blow-outs, fires and spills, all of which could result in personal injuries, loss of life and damage to property of WesternZagros and others; premature declines of reservoirs; environment risks; delay or changes in plans with respect to exploration or development projects or capital expenditures; the ability to attract key personnel; the risk of commodity price and foreign exchange rate fluctuations.

All of WesternZagros's assets are located in the Kurdistan Region of Iraq. As such, WesternZagros is subject to political, economic, and other uncertainties, including, but not limited to, the uncertainty of negotiating with foreign governments, expropriation of property without fair compensation, adverse determinations or rulings by governmental authorities, changes in energy policies or the personnel administering them, nationalization, currency fluctuations and devaluations, disputes between various levels of authorities, arbitrating and enforcing claims against entities that may claim sovereignty, authorities claiming jurisdiction, potential implementation of exchange controls, royalty and government take increases and other risks arising out of foreign governmental sovereignty over the areas in which WesternZagros's operations are conducted, as well as risks of loss due to civil strife, acts of war, guerrilla activities and insurrections. WesternZagros's operations may be adversely affected by changes in government policies and legislation or social instability and other factors which are not within the control of WesternZagros including, among other things, adverse legislation in Iraq and/or the Kurdistan Region, a change in crude oil or natural gas pricing policy, the risks of war, terrorism, abduction, expropriation, nationalization, renegotiation or nullification of existing concessions and contracts, taxation policies, economic sanctions, the imposition of specific drilling obligations and the development and abandonment of fields.

For a complete list of risk factors please refer to Company's Annual Information Form, which is available at [www.westernzagros.com](http://www.westernzagros.com) or on SEDAR at [www.sedar.com](http://www.sedar.com).

## **Adoption of International Financial Reporting Standards (“IFRS”)**

The Company has prepared its June 30, 2011 condensed consolidated interim financial statements in accordance with IAS 34, “Interim Financial Reporting” and in accordance with IFRS 1, “First Time Adoption of International Financial Reporting Standards”. The Company’s first annual reporting date under IFRS will be December 31, 2011. Accordingly, the comparative information for 2010 has been prepared in accordance with the Company’s IFRS accounting policies. The adoption of IFRS has not had a material impact on the Company’s operations, strategic decisions, cash flow, or overall capital expenditures.

The Company’s IFRS accounting policies are provided in detail in Note 3 to the June 30, 2011 Condensed Consolidated Interim Financial Statements. Prior period reconciliations between IFRS and previous GAAP are included within Note 23 to the June 30, 2011 Condensed Consolidated Interim Financial Statements. In summary, Note 23 includes the following reconciliations:

- Balance Sheets as at January 1, 2010, June 30, 2010 and December 31, 2010;
- Statements of Comprehensive Loss for the periods ended June 30, 2010 and December 31, 2010; and
- Statements of Cash Flows for the periods ended June 30, 2010 and December 31, 2010.

## **Financial Statement Impacts Upon Conversion to IFRS**

The following discussion explains the significant impacts on the financial statements upon conversion to IFRS.

### Exploration and Evaluation Expenditures (“E&E”)

WesternZagros previously utilized the full cost method under Canadian GAAP for accounting for its exploration activities in the Kurdistan Region of Iraq. Under the full cost method, all costs associated with the acquisition of, exploration for, and development of crude oil and natural gas, including asset retirement obligations, were capitalized and accumulated within cost centres on a country-by-country basis. Such costs included land acquisition, geological and geophysical activity, drilling and testing of productive and non-productive wells, carrying costs directly related to unproved properties, major development projects as well as insurance and administrative costs directly related to exploration and development activities. As WesternZagros was only operating in the Kurdistan Region of Iraq and had only one Original PSC in that region, it capitalized all costs associated with those exploration activities, including certain costs incurred prior to entering into the Original PSC.

IFRS 1 sets out the procedures that an entity must follow when adopting IFRS as the basis for preparing financial statements. IFRS 1 also provides entities with a number of optional exemptions upon conversion to IFRS, the most significant of which that WesternZagros utilized was the exemption that allows the December 31, 2009 full cost pool under previous GAAP which are related to costs where the technical feasibility and commercial viability have not yet been determined to be reclassified as exploration and evaluation assets under IFRS. This resulted in \$154 million of costs being reclassified from property, plant and equipment (“PP&E”) to E&E expenditures on a deemed costs basis as at January 1, 2010.

Upon conversion to IFRS, WesternZagros was also required to adopt IFRS 6, “Exploration for and Evaluation of Mineral Resources”, which is the standard that deals with accounting for exploration and evaluation expenditures for extractive industries. Typical costs included in the E&E expenditures are acquisition of rights to explore, topographical, geological, geochemical and geophysical studies, exploratory drilling, trenching, sampling, activities in relation to evaluating the technical feasibility and commercial viability of extracting mineral resources, as well as insurance and certain general and administrative costs. Under IFRS 6, costs incurred prior to the legal rights to explore an area being obtained may no longer be capitalized within E&E expenditures. During 2010 the Company reclassified a further \$27 million from PP&E to E&E expenditures. As at December 31, 2010 a total of \$181 million in costs had been reclassified from PP&E under previous GAAP to E&E expenditures relating to the Company’s Original PSC upon conversion to IFRS.

WesternZagros was also required to complete an impairment test of E&E expenditures as at January 1, 2010. There was no impairment of E&E assets upon transition to IFRS.

#### Share Based Payments

The Company previously valued stock option issuances based on each grant as a whole and expensed the valuation of each grant on a straight line basis over the expected lives of the options. Upon conversion to IFRS, the Company was required to adopt IFRS 2, "Share-Based Payment" which provides that the valuation and expensing of share-based payment be done on a graded vesting basis. This resulted in an accelerated expensing of share-based payments based on each individual vesting tranche of options under IFRS as compared to previous GAAP, less the impact of estimated forfeiture rates under IFRS that had not previously been estimated under GAAP. As at January 1, 2010 the adoption of IFRS 2 resulted in an increase in contributed surplus of approximately \$0.9 million, with a corresponding increase in the accumulated deficit. As at December 31, 2010 the adoption of IFRS 2 resulted in a net minor overall decrease in contributed surplus as compared to previous GAAP as the timing of expense recognition was similar between IFRS and previous GAAP at that point in time.

#### Provision for Decommissioning Liabilities

The provisions for decommissioning obligations under IFRS are treated similarly to previous Canadian GAAP, which had previously been disclosed as asset retirement obligations ("ARO"). Upon conversion to IFRS, the Company was required to adopt IAS 37, "Provisions, Contingent Liabilities and Contingent Assets", which required that a risk-free discount rate, *that was not credit risk adjusted*, be applied to the present value calculation of estimated future abandonment costs. This resulted in a lower discount rate utilized in the present value calculation under IFRS as compared to previous GAAP. As a result of the lower discount rate under IFRS, the provision for decommissioning liabilities increased by \$0.3 million under IFRS as at January 1, 2010 and remained at a \$0.3 million increase as at December 31, 2010 when compared to GAAP.

#### Other IFRS 1 Exemptions Utilized

IFRS 1 allows first time adopters of IFRS to utilize a number of voluntary exemptions from the general principle of retrospective treatment. Beyond the full-cost book value as deemed cost exemption utilized for E&E expenditures as discussed in the E&E section of this MD&A, the Company also utilized the allowed exemption relating to IFRS 3, "Business Combinations". Accordingly, IFRS 3 has not been applied to acquisitions that occurred prior to January 1, 2010.

### **CRITICAL ACCOUNTING ESTIMATES**

WesternZagros's critical accounting estimates are defined as those estimates that have a significant impact on the portrayal of its financial position and operations and that require management to make judgments, assumptions and estimates in the application of IFRS. Judgments, assumptions and estimates are based on historical experience and other factors that management believes to be reasonable under current conditions. As events occur and additional information is obtained, these judgments, assumptions and estimates may be subject to change. WesternZagros believes the following are the critical accounting estimates used in the preparation of its consolidated financial statements, which can also be found in Note 5 to the June 30, 2011 Condensed Consolidated Interim Financial Statements.

#### **Use of Estimates**

The preparation of the condensed consolidated interim financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the date of the condensed consolidated interim financial statements, and the reported amounts of revenues and expenses during the reporting period. Such estimates relate to unsettled transactions and events as of the date of the condensed consolidated interim financial statements. Accordingly, actual results may differ from these estimated amounts as future confirming events occur. Significant estimates used in the preparation of the condensed consolidated interim financial statements

include, but are not limited to, recovery of asset carrying values, provision for decommissioning liabilities, incomes tax, and share-based payments.

### **Recoverability of asset carrying values**

At each reporting date, the Company assesses its exploration and evaluation and property, plant and equipment expenditures for possible impairment if events or circumstances indicate the carrying values of the assets might not be recoverable. Relevant indicators include the following: the continued progression of Management's operational plans; new information obtained from wells that have been drilled or tested; changes or restrictions in access to drilling sites; changes in legal, regulatory, market, environmental, technological, or political factors that could impact ongoing operations; the ability of the Company to continue fulfilling ongoing commitments; and significant changes in the Company's market value.

If factors indicate that the Company may need to recognize impairment, the carrying value of the assets for each cash-generating-unit is compared to the greater of value-in-use or fair-value less costs to sell. It is anticipated that the value-in-use model, based on discounted estimated future net cash flows, would be more readily computed. Determination of the value-in-use amount and any resulting impairment involves the use of significant estimates and assumptions about future events and factors such as future commodity prices, the impact of inflation on operating expenses, discount rates, production profiles, the ability to produce and export crude oil and natural gas, the future capital costs needed to develop reserves, as well as the future marketability and availability of transportation for crude oil and natural gas that is produced.

At the reporting date, the Company is still in the exploration phase of operations on its PSC Lands. The Company has not recognized any impairment for exploration and evaluation expenditures nor for property, plant, and equipment.

### **Provision for decommissioning obligations**

The Company recognizes both an asset and a provision for decommissioning obligations in the period in which they are incurred by estimating the fair value of the obligation. Provisions for environmental clean-up and remediation costs associated with the Company's drilling operations are based on current legal and constructive requirements, technology, price levels and expected plans for remediation. Actual costs and cash outflows and the timing of those cash outflows can differ from estimates because of changes in laws and regulations, public expectations, prices, discovery and analysis of site conditions, future performance of wells drilled, and changes in clean-up technology. Estimating the timing and amount of cash outflows required to settle these obligations are inherently difficult and are based on Management's current experience. A risk free rate has been used in the calculations. Any differences between actual and estimated decommissioning obligations would impact both the asset and the provision which then would impact future depletion on the asset as well as accretion on the provision.

### **Income tax**

Tax regulations and legislation and the interpretations thereof in the jurisdictions that the Company operates are subject to change. As such, income taxes are subject to measurement uncertainty. Deferred income tax assets are assessed by Management based on all available information at the end of the reporting period to determine the likelihood that they will be realized from future taxable earnings.

### **Share-based payments**

The estimates, assumptions, and judgments made in relation to the fair value of share-based payments and the associated expense recognition is subject to measurement uncertainty. The fair value of employee 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, expected life of the instrument, estimated forfeitures, expected dividends, and the risk-free interest rate.

### **Recent accounting pronouncements issued but not yet effective**

The IASB has issued the following standards which are effective for annual periods beginning on or after January 1, 2013, with early adoption permitted. The Company is currently evaluating the impact, if any, of each of these new standards, which are briefly summarized as follows:

IAS 27 – Separate Financial Statements:

IAS 27 replaces the existing IAS 28, “Consolidated and Separate Financial Statements”. IAS 27 contains accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements. IAS 27 requires an entity preparing separate financial statements to account for those investments at cost or in accordance with IFRS 9, “Financial Instruments”.

IAS 28 – Investments in Associates and Joint Ventures:

IAS 28 prescribes the accounting for investments in associates and sets out the application of the equity method when accounting for investments in associates and joint ventures.

IFRS 9 - Financial Instruments:

IFRS 9 is the first part of a new standard on classification and measurement of financial assets and liabilities that will replace IAS 39, “Financial Instruments: Recognition and Measurements”.

For financial assets, IFRS 9 has two measurement categories: amortized cost and fair value. All equity instruments are measured at fair value. A debt instrument is at amortized cost only if the entity is holding it to collect contractual cash flows and the cash flows represent principal and interest. Otherwise it is at fair value through profit and loss.

For financial liabilities, although the classification criteria for financial liabilities will not change under IFRS 9, the approach to the fair value option for financial liabilities may require different accounting for changes to the fair value of a financial liability as a result of changes to an entity’s own credit risk.

IFRS 10 – Consolidated Financial Statements:

IFRS 10 establishes the principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. IFRS 10 replaces IAS 27 “Consolidated and Separate Financial Statements” and SIC-12 “Consolidation – Special Purpose Entities”.

IFRS 11 – Joint Arrangements:

IFRS 11 establishes principles for financial reporting by parties to a joint arrangement, and requires entities to classify interests in joint arrangements as either a joint venture or a joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for joint operations the entity will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. IFRS 11 replaces IAS 31 “Interests in Joint Ventures” and SIC-13 “Jointly Controlled Entities – Non-monetary Contributions by Venturers”.

IFRS 12 – Disclosure of Interests in Other Entities:

IFRS 12 establishes disclosure requirements relating to an entity’s interests in other entities such as joint arrangements, associates or unconsolidated structured entities, including special purpose vehicles and off balance sheet vehicles. The standard carries forward existing disclosure requirements and also introduces significant additional disclosure requirements that address the nature and risk associated with interests in other entities.

IFRS 13 – Fair Value Measurements:

IFRS 13 defines fair value and sets out a single IFRS framework for measuring fair value and the required disclosures about fair value measurements for use across all IFRS standards. IFRS 13 is intended to eliminate the inconsistencies in fair value measurement and the disclosure requirements contained in various other IFRS standards that refer to fair value.

**Condensed consolidated interim statements of financial position**  
**(United States dollars thousands)**  
(Unaudited)

	Note	June 30, 2011	December 31, 2010 (Note 23)	January 1, 2010 (Note 23)
<b>Assets</b>				
<b>Current assets</b>				
Cash and cash equivalents	7	\$50,668	\$31,482	\$76,708
Trade and other receivables	8	2,955	8,648	6,880
Insurance recoveries receivable	9	4,446	17,597	-
Deposits held in trust	11	-	420	-
Prepaid expenses		459	39	183
Income tax recoverable	12	1,804	887	1,738
<b>Total current assets</b>		<b>60,332</b>	59,073	85,509
<b>Non-current assets</b>				
Deposits held in trust	11	-	-	420
Property, plant and equipment	10	160	261	814
Exploration and evaluation expenditures	9	211,992	180,770	154,097
Deferred tax assets	12	166	186	371
<b>Total non-current assets</b>		<b>212,318</b>	181,217	155,702
<b>Total assets</b>		<b>\$272,650</b>	\$240,290	\$241,211
<b>Liabilities</b>				
<b>Current liabilities</b>				
Trade and other payables	13	\$13,634	\$21,525	\$18,297
<b>Total current liabilities</b>		<b>13,634</b>	21,525	18,297
<b>Non-current liabilities</b>				
Provision for decommissioning obligations	14	706	509	432
Deferred tax liabilities	12	158	140	134
<b>Total non-current liabilities</b>		<b>864</b>	649	566
<b>Total liabilities</b>		<b>14,498</b>	22,174	18,863
<b>Equity</b>				
Share capital	15	295,783	253,583	253,583
Contributed surplus	16	11,955	11,223	9,654
Deficit		(49,586)	(46,690)	(40,889)
<b>Total equity</b>		<b>258,152</b>	218,116	222,348
<b>Total equity and liabilities</b>		<b>\$272,650</b>	\$240,290	\$241,211

Subsequent events, commitments and contingencies (Note 22)

*The notes are an integral part of these condensed consolidated interim financial statements.*

These condensed consolidated interim financial statements were authorized for issue by the Board of Directors on August 11, 2011. They are signed on the Company's behalf by:

(Signed) "Fred J. Dymant"  
Director

(Signed) "Randall Oliphant"  
Director

**Condensed consolidated interim statements of comprehensive loss**  
**(United States dollars thousands, except per share amounts)**  
(Unaudited)

	Note	Three months ended June 30,		Six months ended June 30,	
		2011	2010	2011	2010
<b>Revenue</b>					
Other income		\$34	\$17	\$51	\$36
<b>Expenses</b>					
General and administrative expenses	17, 18	1,847	1,483	3,643	3,246
Depreciation		51	132	101	311
Accretion	14	6	4	12	8
Foreign exchange (gain)loss		(77)	193	71	245
Total expenses		1,827	1,812	3,827	3,810
<b>Loss before taxation</b>		<b>1,793</b>	1,795	<b>3,776</b>	3,774
<b>Taxation</b>					
Current	12	(452)	(207)	(917)	(904)
Deferred	12	75	58	37	109
Total taxation (recovery)		(377)	(149)	(880)	(795)
<b>Total loss and comprehensive loss for the period attributable to the shareholders</b>					
		<b>\$1,416</b>	\$1,646	<b>\$ 2,896</b>	\$2,979
<b>Net loss per share</b>					
– basic and diluted	19	<b>\$0.005</b>	\$0.008	<b>\$0.011</b>	\$0.014

*The notes are an integral part of these condensed consolidated interim financial statements.*

**Condensed consolidated interim statements of changes in equity**  
**(United States dollars thousands)**  
(Unaudited)

	Note	Number of shares	Share capital	Contributed surplus	Accumulated deficit	Total equity
<b>Balance January 1, 2010</b>	23	207,464,320	\$253,583	\$ 9,654	\$(40,889)	\$ 222,348
Share based payments		-	-	442	-	442
Loss for the period		-	-	-	(2,979)	(2,979)
<b>Balance June 30, 2010</b>	23	207,464,320	253,583	10,096	(43,868)	219,811
Share based payments		-	-	1,127	-	1,127
Loss for the period		-	-	-	(2,822)	(2,822)
<b>Balance December 31, 2010</b>	23	207,464,320	253,583	11,223	(46,690)	218,116
Issuance of common shares		89,665,352	44,227	-	-	44,227
Options exercised	16	9,200	7	(2)	-	5
Share issuance costs		-	(2,034)	-	-	(2,034)
Share based payments	16, 17	-	-	734	-	734
Loss for the period		-	-	-	(2,896)	(2,896)
<b>Balance June 30, 2011</b>		297,138,872	\$295,783	\$11,955	(49,586)	\$258,152

*The notes are an integral part of these condensed consolidated interim financial statements.*

**Condensed consolidated interim statements of cash flows**  
**(United States dollars thousands)**  
(Unaudited)

	Note	Three months ended June 30, 2011	2010	Six months ended June 30, 2011	2010
<b>Cash flow from operating activities</b>					
Net loss before taxation		\$(1,793)	\$(1,795)	\$(3,776)	\$(3,774)
Adjustments for					
Depreciation		51	132	101	311
Accretion	14	6	4	12	8
Share based payments	16, 17	193	214	438	487
Income tax recovered (paid)		-	598	-	598
Change in non-cash operating working capital	21	(1,646)	48	(1,698)	(259)
Net cash from (used in) operating activities		(3,189)	(799)	(4,923)	(2,629)
<b>Cash flow from investing activities</b>					
Expenditures on exploration and evaluation	21	(15,721)	(15,895)	(34,750)	(35,690)
Disposals of assets		-	-	461	-
Insurance recoveries	9	4,695	5,380	16,200	5,380
Net cash from (used in) investing activities		(11,026)	(10,515)	(18,089)	(30,310)
<b>Cash flow from financing activities</b>					
Issuance of common shares, net of costs		15	-	42,193	-
Proceeds from options exercised		5	-	5	-
Net cash from (used in) financing activities		20	-	42,198	-
<b>Change in cash and cash equivalents</b>		<b>(14,195)</b>	<b>(11,314)</b>	<b>19,186</b>	<b>(32,939)</b>
Cash and cash equivalents, beginning of period		64,863	55,083	31,482	76,708
<b>Cash and cash equivalents, end of period</b>		<b>\$50,668</b>	<b>\$43,769</b>	<b>\$50,668</b>	<b>\$43,769</b>

*The notes are an integral part of these condensed consolidated interim financial statements.*

**Notes to the condensed consolidated interim financial statements**  
**For the three and six months ended June 30, 2011 and 2010**  
*(Tabular amounts in United States dollars thousands)*  
*(Unaudited)*

**1. General information**

WesternZagros Resources Ltd. (the “Company” or “WesternZagros”) is headquartered in Calgary, Canada. The Company is incorporated under the laws of the Province of Alberta, Canada. The registered address for the Company is Suite 600, 440 – 2<sup>nd</sup> Avenue S.W., Calgary, Alberta, T2P 5E9.

WesternZagros is a publicly-traded, Calgary-based, international oil and gas company engaged in acquiring properties and exploring for, developing and producing crude oil and natural gas in Iraq. WesternZagros holds two Production Sharing Contracts (“PSCs”) with the Kurdistan Regional Government (“KRG”) in the Kurdistan Region of Iraq. Each PSC governs a separate contract area. The northern contract area (comprising some 340 square kilometres) is governed by the Kurdamir PSC which is an amended version of the original February 28, 2008 PSC that governed all of the Kalar-Bawanoor Block (the “Original PSC”) and is now called the Kurdamir Block. The southern contract area (comprising some 1,780 square kilometres) is governed under the new Garmian PSC and is named the Garmian Block. WesternZagros holds a 40 percent working interest in both the Kurdamir and Garmian PSCs. The KRG holds a 20 percent working interest in both PSCs. The remaining 40 percent working interest (the third party participation interest or “TPPI”) of the Kurdamir PSC is held by a wholly-owned subsidiary of Talisman Energy Inc. (“Talisman”). The remaining 40 percent TPPI of the Garmian PSC is held by the KRG and it is to be assigned to a third party participant (refer to Note 22 “Subsequent events, commitments and contingencies” for a description of the PSCs).

The Company has its listing on the TSX Venture Exchange under the symbol “WZR.V”.

**Authorization of financial statements**

These condensed consolidated interim financial statements as at and for the three and six months ended June 30, 2011 were authorized for issuance in accordance with a resolution of the Audit Committee of the Board of Directors on August 11, 2011.

**2. Basis of preparation**

These condensed consolidated interim financial statements, including prior year comparative information, have been prepared in accordance with International Accounting Standard (“IAS”) 34, Interim Financial Reporting, and International Financial Reporting Standard 1, First Time Adoption of IFRS, using accounting policies consistent with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”), and interpretations issued by the IFRS Interpretations Committee, that are published at the time of preparation and that are effective or available for early adoption on December 31, 2011, the Company’s first annual reporting date under IFRS. Prior to 2011, the Company prepared its consolidated annual and consolidated interim financial statements in accordance with Canadian generally accepted accounting principles (“GAAP”).

These condensed consolidated interim financial statements have been prepared on a going concern basis under the historical cost convention. These condensed consolidated interim financial statements should be read in conjunction with the Company’s annual financial statements and the notes thereto in the Company’s annual report for the year ended December 31, 2010, which were prepared in accordance with previous GAAP.

As is typical with exploration stage companies, the Company has incurred losses from operations and negative cash flows from operating activities, and has an accumulated deficit at June 30, 2011. During the three months ended June 30, 2011, the Company had expenditures of \$3.2 million for operating activities and \$11.0 million for investing activities related to exploration and evaluation assets, including changes in

non-cash working capital. During the six months ended June 30, 2011, the Company had expenditures of \$4.9 million for operating activities and \$18.1 million for investing activities related to exploration and evaluation assets, including changes in non-cash working capital. The Company will require additional funding over time to maintain ongoing exploration programs and property commitments, as well as for administration expenses. In general, the Company's ability to continue operations and exploration activities is dependent upon its ability to obtain additional funding over time. While the Company has been successful in obtaining its required funding in the past, there is no assurance that sufficient funds will be available to the Company in the future, or if available, available on favourable terms. Factors that could affect the availability of financing include the continued support of its shareholders; the results of exploration activities; the potential assignment by the KRG of the third party participant interest in the Garmian PSC and timing thereof (see Note 22 "Subsequent events, commitment and contingencies" for a description of the PSCs); the results and timing associated with potential future production and sales; the political climate in Iraq and the general effect it has on the oil and gas industry; and the overall state of the capital markets. This requirement for funding may occur during the fiscal year ending December 31, 2011 and is dependent on the level and timing of exploration activities pursued by the Company and the funding requirement of the Company under the relevant PSCs.

The Company realizes that the combination of circumstances and risks represent an uncertainty that may cast doubt upon the Company's ability to realize its assets and discharge its liabilities in the normal course of business. Nevertheless, after considering the uncertainties, Management has a reasonable expectation that the Company has adequate resources or can raise the additional resources required in order to continue to adopt the going concern basis of accounting in preparing the financial statements.

### **3. Significant accounting policies**

The significant accounting policies used in the preparation of these condensed consolidated interim financial statements are described below.

#### **A. Conversion to IFRS**

The Canadian Accounting Standards Board ("AcSB") confirmed in February 2008 that IFRS would replace Canadian generally accepted accounting principles for publicly accountable enterprises for financial periods beginning on or after January 1, 2011.

These condensed consolidated interim financial statements present the Company's financial results of operations and financial position, prepared in accordance with IFRS, as at and for the three and six months ended June 30, 2011. The Company's transition date to IFRS is January 1, 2010. Consequently, the comparative figures for 2010 and the Company's consolidated statement of financial position as at January 1, 2010 have been restated from GAAP to comply with IFRS. The reconciliations between previously reported GAAP and IFRS are explained in Note 23 of these condensed consolidated interim financial statements.

## B. Basis of measurement

These condensed consolidated interim financial statements have been prepared on a historical costs basis, and have been prepared using the accrual basis of accounting, except for certain cash flow information. The accounting policies, as described in further detail in this note, have been consistently applied to all periods presented in these condensed consolidated interim financial statements. They also have been applied in preparing an opening statement of financial position at January 1, 2010 for the purposes of transition to IFRS as required by IFRS 1, First Time Adoption of International Financial Reporting Standards.

These condensed consolidated interim financial statements, unless otherwise indicated, are expressed in United States dollars ("US"). The company has adopted the US dollar as its functional and reporting currency since most of its expenses are directly or indirectly denominated in US dollars. When revenues are realized, it is expected that US dollars would be received. All references herein to U.S. \$ or to \$ are to United States dollars and references herein to Cdn \$ are to Canadian dollars. These condensed consolidated interim financial statements are rounded to the nearest thousand (U.S. \$000) except where otherwise indicated.

The preparation of these condensed consolidated interim financial statements in conformity with IFRS requires the use of critical accounting estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the reporting date, as well as the reported amounts of revenues and expenses during the reporting period. Such estimates relate to unsettled transactions and events at the reporting date. Accordingly, actual results may ultimately differ from the estimated amounts as future confirming events occur. Areas that involve a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the condensed consolidated interim financial statements are disclosed in Note 5.

## C. Basis of consolidation

These condensed consolidated interim financial statements include the accounts of the Company and its wholly-owned subsidiaries as follows:

<u>Wholly-owned subsidiary</u>	<u>Jurisdiction</u>	<u>Nature of operations</u>
WesternZagros Resources Inc.	Canada	Holding Company
Western Oil International Holdings Limited	Cyprus	Holding Company
WesternZagros Limited	Cyprus	Exploration Company

These subsidiaries are entities over which the Company has the power to govern the financial and operating policies. The Company has 100 percent direct ownership of these entities. Accordingly, the subsidiaries are fully consolidated within the Company's condensed consolidated interim financial statements.

Inter-company transactions and balances, including unrealized income and expenses arising from inter-company transactions, are eliminated in full in preparing these condensed consolidated interim financial statements.

#### **D. Jointly controlled assets under the PSCs**

The jointly controlled assets under the PSCs offer joint ownership by the Company and its co-venturers to the PSCs for assets contributed to the ongoing exploration project in the Kurdistan Region of Iraq. The Company recognizes its share of the jointly controlled assets and its share of the joint liabilities incurred under the PSCs (refer to Note 22 “Subsequent events, commitments and contingencies” for a description of the PSCs).

#### **E. Foreign currency translation**

These condensed consolidated interim consolidated financial statements are presented in U.S. dollars, which is the Company’s functional and reporting currency.

Transactions in currencies other than the functional currency are recorded at the rates of exchange prevailing on the dates of the transactions. At the reporting date, monetary assets and liabilities that are denominated in foreign currencies are translated at the exchange rates prevailing at the date of the statement of financial position. Non-monetary items are measured at historical exchange rates.

#### **F. Exploration and evaluation expenditures**

Crude oil and natural gas exploration and evaluation expenditures are accounted for using a modified ‘successful efforts’ method of accounting. Accordingly, the Company accounts for its share of costs relating to the acquisition of, exploration for, and evaluation of crude oil and natural gas assets, including related provisions for decommissioning liabilities, as exploration and evaluation expenditures. Exploration and evaluation costs include, but are not limited to, license and land acquisition costs; topographical, geological, geochemical, and geophysical costs or studies; drilling and testing of exploratory and non-productive wells; costs related to evaluating the technical feasibility or commercial viability of extracting mineral reserves; carrying costs directly related to unproved properties; major development projects; and administrative costs directly related to exploration and evaluation activities.

The costs continue to be carried as exploration and evaluation expenditures until such time that the technical feasibility and commercial viability of the crude oil and natural gas hydrocarbons has been demonstrated and development of reserves has been sanctioned. At that point the exploration and evaluation expenditures are assessed for impairment and then transferred to development expenditures. As at the date of these financial statements the Company is an exploration stage company and has not yet incurred any development expenditures.

Accumulated exploration and evaluation expenditures are assessed for impairment if: a) sufficient data exists to determine technical feasibility and commercial viability; and b) facts or circumstances suggest the carrying amount exceeds the recoverable amount. Indicators of impairment are considered at least annually or whenever facts and circumstances indicate potential impairment. For the purposes of impairment testing, exploration and evaluation expenditures are allocated on a cash-generating unit (“CGU”) basis. The Company has established that each PSC entered into will be identified as a separate CGU. An impairment loss is recognized for the amount by which the exploration and evaluation expenditure’s carrying value exceeds its recoverable amount. The recoverable amount is the higher of the exploration and evaluation expenditure’s fair value less costs to sell and their value in use. Impairment losses are recognized immediately in the statement of comprehensive income (loss). If facts and circumstances subsequently indicate that a reversal of a previous impairment loss is warranted, the carrying value is increased up to the recoverable amount, with the reversal limited to the original loss amount. As at the reporting date no impairment has been recognized.

No depreciation or amortization is charged against exploration and evaluation assets.

## G. Property, plant and equipment (“PP&E”)

Property, plant and equipment are stated at historical cost, less depreciation, and are depreciated on a straight-line basis over their estimated useful lives based on the following annual rates:

Furniture, fixtures and office equipment	20-33%
Computer hardware and software	33-50%

Whenever events or circumstances dictate, the Company compares the carrying value of other property, plant and equipment to estimated net recoverable amounts, based on estimated discounted future cash flows, to determine whether there is any indication of impairment.

## H. Cash and cash equivalents

Cash and cash equivalents consist of cash in the bank, less outstanding cheques, and short-term deposits with original maturity dates of three months or less.

## I. Financial instruments

Financial assets and liabilities are recognized on the Company’s statement of financial position when the Company becomes party to the contractual provisions of the instrument. Financial assets are de-recognized when the contractual rights to the cash flows from the financial assets expire or when the contractual rights to those assets are transferred. Financial liabilities are derecognized when the obligation specified in the contract is discharged, cancelled, or expired.

Upon initial recognition, the Company classifies its financial instruments into one of the following categories based on the purpose for which the instruments were acquired:

*Financial assets and liabilities at fair value through profit or loss* – this category is comprised of derivatives, or assets acquired or incurred principally for the purpose of selling or repurchasing in the near term, except for those derivatives designated as hedges. They are carried in the statement of financial position at fair value with changes in fair value recognized in the comprehensive statement of income (loss) for the period. The Company has not classified any instruments in this category, and has not identified any material embedded derivatives in any of its financial instruments.

*Available-for-sale financial assets* – this category is comprised of non-derivative investments designated as available for sale and can include marketable securities and investments in debt and equity securities. Available-for-sale investments are recognized initially at fair value plus transaction costs and are subsequently carried at fair value. Gains or losses arising from changes in fair value are recognized in other comprehensive income. Available-for-sale investments are classified as non-current, unless the investments mature within twelve months, or management expects to dispose of them within twelve months. The Company has not classified any instruments in this category.

*Loans and receivables* – this category is comprised of non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The Company’s loans and receivables are comprised of cash and cash equivalents, trade and other receivables, insurance recoveries receivable, deposits held in trust and income tax recoverable and are included in current assets due to their short-term nature.

Loans and receivables are initially recognized at the amount expected to be received less, when material, a discount to reduce the loans and receivables to fair value. Subsequently, loans and receivables are measured at amortized cost using the effective interest rate method.

*Financial liabilities at amortized cost* – this category is comprised of financial liabilities measured at amortized cost using the effective interest rate method, which includes trade and other payables.

## **J. Impairment of financial instruments**

At each reporting date, the Company assesses whether there is objective evidence that a financial asset is impaired. If such evidence exists, the Company recognizes an impairment loss as follows:

*Financial assets carried at amortized cost* – the impairment loss is the difference between the amortized cost of the loan or receivable and the present value of the estimated future cash flows, discounted using the instrument's original effective interest rate. The carrying amount of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

*Available for sale financial assets* – the impairment loss is the difference between the original cost of the asset and its fair value at the measurement date, less any impairment losses previously recognized in the statement of loss. This amount represents the cumulative loss in accumulated other comprehensive income that is reclassified to net income.

Impairment losses on financial instruments carried at amortized cost are reversed in subsequent periods if the amount of the loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized. Impairment losses on available-for-sale equity instruments are not reversed.

## **K. Provision for decommissioning obligations**

Provision for decommissioning obligations are recognized when the Company has a present legal or constructive obligation as a result of past events, and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount of obligation can be made. Provision is made for the present value of the future cost of abandonment of oil and gas wells and related facilities. The Company recognizes the initial spud date as the obligating event for each well location. The Company currently has no other facilities or infrastructure relating to petroleum operations that would require future abandonment activities. When the provision is first recognized a corresponding amount equivalent to the provision is also currently recognized as part of the cost of exploration and evaluation expenditures.

The amount recognized is the estimated cost of decommissioning activities based on internal engineering estimates prevailing at the reporting date, discounted to its present value utilizing a pre-tax risk-free interest rate. Changes in the estimated timing of decommissioning or decommissioning cost estimates are dealt with prospectively by recording an adjustment to the provision, with a corresponding adjustment to exploration and evaluation expenditures, and are updated at each reporting date to reflect the current market assessments of the time value of money and the risks specific to the obligation.

The liability is increased each period due to the passage of time and the associated accretion is expensed to income in the period.

## **L. Taxation including deferred taxation**

Tax expense represents current tax and deferred tax. Income tax is recognized in the statement of income or loss except to the extent that it relates to items directly in equity, in which case the related income tax impact is recognized in equity.

Current tax is based on the taxable profits for the period and any adjustment to tax payable or receivable in respect of previous years.

Deferred tax assets and liabilities are determined on a non-discounted basis, using the liability method, based on the differences between the carrying values in the condensed consolidated interim financial statements and the tax bases of assets and liabilities. Deferred tax assets are recognized to the extent that it is probable that the assets can be recovered. Deferred income tax assets and liabilities are presented as non-current.

Deferred taxes are calculated using tax rates that have been enacted or substantively enacted by the reporting date.

Taxes on income in interim periods are accrued using the tax rate that would be applicable to expected total annual earnings.

#### **M. Share capital**

Common shares are classified as equity. Incremental costs directly attributable to the issuance of shares are recognized as a deduction from equity.

#### **N. Share-based payments**

The Company has established a Stock Option Plan for the issuance of options to directors, officers, employees and consultants to purchase Common Shares of the Company. The vesting period and expiry date for each option grant is set at the discretion of the Board of Directors. Each vesting tranche is considered a separate award with its own vesting period. The fair value of each tranche is measured at the grant date using the Black-Scholes option pricing model. Compensation costs are recognized over the vesting period for each particular tranche based on the number of awards expected to vest, with a corresponding increase to contributed surplus. Compensation costs directly related to exploration activities are capitalized, costs related to non-exploration activities are treated as general and administrative expenses. The number of option awards expected to vest is reviewed at least annually, with any impact being recognized immediately.

The cash proceeds received, net of any directly attributable transaction costs, together with the amount recorded to contributed surplus are credited to share capital when the options are exercised.

#### **O. Revenue**

The Company recognizes revenue on an accrual basis, which is related to the interest income earned on the Company's cash and cash equivalents balances.

#### **P. Fair value**

The fair value of instruments, trade and other receivables, and trade and other payables approximate their carrying amounts due to the short term maturity of the instruments.

#### **Q. Loss per share**

The Company presents the basic and diluted loss per share data for its common shares, calculated by dividing the loss attributable to the shareholders of the Company by the weighted-average number of common shares outstanding during the period. Diluted income per share is determined by adjusting the income attributable to the common shareholders and the average number of common shares outstanding for the period for the effects of all potential dilutive common shares. Note that by definition, for periods in which there is a loss attributable to the common shareholders, there can be no dilutive impact on the loss per share calculation.

## **R. Recent accounting pronouncements issued but not yet effective**

The IASB has issued the following standards which are effective for annual periods beginning on or after January 1, 2013, with early adoption permitted. The Company is currently evaluating the impact, if any, of each of these new standards, which are briefly summarized as follows:

### IAS 27 – Separate Financial Statements:

IAS 27 replaces the existing IAS 28, “Consolidated and Separate Financial Statements”. IAS 27 contains accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements. IAS 27 requires an entity preparing separate financial statements to account for those investments at cost or in accordance with IFRS 9, “Financial Instruments”.

### IAS 28 – Investments in Associates and Joint Ventures:

IAS 28 prescribes the accounting for investments in associates and sets out the application of the equity method when accounting for investments in associates and joint ventures.

### IFRS 9 - Financial Instruments:

IFRS 9 is the first part of a new standard on classification and measurement of financial assets and liabilities that will replace IAS 39, “Financial Instruments: Recognition and Measurements”.

For financial assets, IFRS 9 has two measurement categories: amortized cost and fair value. All equity instruments are measured at fair value. A debt instrument is at amortized cost only if the entity is holding it to collect contractual cash flows and the cash flows represent principal and interest. Otherwise it is at fair value through profit and loss.

For financial liabilities, although the classification criteria for financial liabilities will not change under IFRS 9, the approach to the fair value option for financial liabilities may require different accounting for changes to the fair value of a financial liability as a result of changes to an entity’s own credit risk.

### IFRS 10 – Consolidated Financial Statements:

IFRS 10 establishes the principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. IFRS 10 replaces IAS 27 “Consolidated and Separate Financial Statements” and SIC-12 “Consolidation – Special Purpose Entities”.

### IFRS 11 – Joint Arrangements:

IFRS 11 establishes principles for financial reporting by parties to a joint arrangement, and requires entities to classify interests in joint arrangements as either a joint venture or a joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for joint operations the entity will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. IFRS 11 replaces IAS 31 “Interests in Joint Ventures” and SIC-13 “Jointly Controlled Entities – Non-monetary Contributions by Venturers”.

#### IFRS 12 – Disclosure of Interests in Other Entities:

IFRS 12 establishes disclosure requirements relating to an entity's interests in other entities such as joint arrangements, associates or unconsolidated structured entities, including special purpose vehicles and off balance sheet vehicles. The standard carries forward existing disclosure requirements and also introduces significant additional disclosure requirements that address the nature and risk associated with interests in other entities.

#### IFRS 13 – Fair Value Measurements:

IFRS 13 defines fair value and sets out a single IFRS framework for measuring fair value and the required disclosures about fair value measurements for use across all IFRS standards. IFRS 13 is intended to eliminate the inconsistencies in fair value measurement and the disclosure requirements contained in various other IFRS standards that refer to fair value.

## **4. Financial risk management**

The Company's financial instruments consist of cash and cash equivalents, trade and other receivables, insurance recoveries receivable, deposits held in trust, and trade and other payables. The main risks that could adversely affect the Company's financial instruments are credit risk, liquidity and funding risk, and market and interest rate risk.

Risk management is carried out by senior management, in particular, the Board of Directors. The risk management policies employed by the Company are discussed below:

#### Credit risk

Credit risk is the risk of loss associated with the counterparty's inability to fulfill its payment obligations. The Company is currently exposed to credit risk on its cash and cash equivalents to the extent these balances are invested with various institutions. The Board of Directors of the Company has approved an Investment Policy to dictate the various types of instruments and institutions that can be invested in and monitors these against this policy on a regular basis. Currently, the Company has entered into transactions for cash equivalents with major Canadian financial institutions with investment grade credit ratings.

The Company is also normally exposed to credit risk on trade and other receivables, mainly associated with its role as operator in both PSCs, including Talisman's 40 percent interest in the Kurdamir PSC and its share of related expenditures and the potential reimbursement of costs incurred under the Garmian PSC that may ultimately be due upon assignment by the KRG of the third party participant in the Garmian PSC. Accordingly, the ability of the Company to successfully carry out the exploration, appraisal and development of its PSC contract areas may be impacted by the continued participation of the parties in these activities and the potential assignment of the third party participant interest in the Garmian PSC by the KRG and any corresponding reimbursement of costs incurred under the Garmian PSC (refer to Note 22 "Subsequent events, commitments and contingencies" for a description of the PSCs). As at June 30, 2011, the Company had a net receivable balance owing from Talisman of \$2.8 million for its share of expenditures under the terms of the Original PSC, including penalty provisions for any amounts in default (also refer to Note 22 "Subsequent events, commitments and contingencies").

With respect to the Company's financial assets, the maximum exposure to credit risk due to default of a counter party is equal to the carrying value of these instruments. The maximum exposure to credit risk as at the reporting date is as follows:

<b>As at</b>	<b>June 30, 2011</b>	<b>December 31, 2010</b>
Cash and cash equivalents	\$50,668	\$ 31,482
Trade and other receivables	2,955	8,648
Insurance recoveries receivable	4,446	17,597
Deposits held in trust	-	420
<b>Total</b>	<b>\$58,069</b>	<b>\$ 58,147</b>

The Company does not expect any losses from non-performance by these counterparties, and has not recorded a provision against any of these amounts as it does not consider the balances to be impaired.

#### Liquidity and funding risk

Liquidity and funding risk is the risk that the Company may be unable to generate or obtain sufficient cash or its equivalent in a timely and cost-effective manner to meet its commitments as they become due. As the Company is engaged in acquiring properties and exploring for crude oil and natural gas and is in the exploration phase, it currently does not have a revenue source outside of interest on its cash and cash equivalent balances. The Company is therefore required to fund its share of all commitments from existing balances or access additional sources of funding from debt or equity markets.

The Company's capital structure consists of shareholder's equity and working capital. The Company will adjust its capital structure to manage its drilling program through the issuance of shares and adjustments to capital spending.

The Company's objectives when managing its capital structure are as follows:

- i. Ensure adequate levels of available cash and cash equivalents to meet the Company's commitments under the Garmian and Kurdamir PSCs (also refer to Note 22 "Subsequent events, commitments and contingencies"); and
- ii. To prudently fund expenditures related to the acquisition of properties, and for exploration, appraisal and development of crude oil and natural gas properties.

The Company funds its share of expenditures of all commitments from existing cash and cash equivalent balances received primarily from issuances of shareholder's equity. The Company has not entered into any debt financing arrangements as at the reporting date and is not subject to any externally imposed capital requirements. Trade and other payables of \$13.6 million are all current liabilities due in less than 1 year. Certain commitments of approximately \$8.3 million identified in Note 22 are also due within 1 year of the reporting date.

The Board of Directors regularly reviews the Company's cash and cash equivalents against the Company's expenditure commitments and assesses the need and timing for additional financing. This review includes assessing the likelihood and timing of an assignment of the third party participant interest by the KRG under the Garmian PSC and any corresponding reimbursement of costs under the Garmian PSC (refer to Note 22 "Subsequent events, commitments and contingencies for a description of the PSCs), as well as an assessment of any potential revenue to be derived from crude oil sales during any extended well testing. Management has a reasonable expectation that the Company can raise the additional capital required in order to meet future expenditures. However, the Company's results will impact its access to the capital necessary to meet these expenditure commitments. There can be no assurance that debt or equity financing will be available or sufficient to meet those commitments, or for other corporate purposes, or if debt or equity financing is available, that it will be on terms acceptable to the Company. The inability of the Company to access sufficient capital for its operations could have a material adverse impact on the Company's financial condition, results of operations and prospects.

#### Market and interest rate risk

Market risk is the risk of loss that may arise from changes in market factors such as interest rates, foreign exchange rates and equity or commodity prices. The Company is exposed to interest rate risk to the extent that changes in market interest rates will impact interest earned on the Company's cash and cash equivalents. The Company is also exposed to foreign exchange risk, as the majority of costs are anticipated to be incurred in U.S. dollars while the funds it will have available to it may be in other currencies.

The Company's Investment Policy dictates the various types of instruments and institutions that can be invested in and monitors these against this policy on a regular basis. The Board of Directors has also approved a Foreign Exchange Policy to dictate the currencies held by the Company and the instruments that can be utilized by the Company to meet its day to day requirements. This Foreign Exchange Policy requires the Company to hold the majority of its cash and cash equivalents and short term investments in U.S. dollars and sets out the type and duration of instruments that can be used to meet the Company's day to day foreign exchange requirements. The Foreign Exchange Policy does allow the Company to hold other balances, mainly Canadian dollars, to meet its funding needs for general and administrative and other spending requirements in these currencies. Neither aforementioned policy permits the Company to enter into any economic hedging as it relates to interest or foreign exchange risks. As at June 30, 2011, had the U.S. dollar changed by one percent against the Canadian dollar, with all other variables held constant, the Company's foreign exchange gain (loss) would have been affected by approximately \$0.1 million

The marketability and price of crude oil and natural gas that may be acquired or discovered by the Company is, and will continue to be, affected by numerous factors beyond its control including the impact that the various levels of government may have on the ultimate price received for crude oil and natural gas sales. The Company's ability to market its crude oil and natural gas may depend on its ability to secure transportation. The Company may also be affected by deliverability uncertainties related to the proximity of its potential production to pipelines and processing facilities and operational problems affecting such pipelines and facilities as well as potential government regulation relating to price, the export of crude oil and natural gas and other aspects of the crude oil and natural gas business.

Both crude oil and natural gas prices are subject to wide fluctuation. During the six months ended June 30, 2011, West Texas Intermediate crude prices ranged in value from \$83 to \$113 per barrel. WesternZagros originally negotiated the economic terms of the Original PSC in 2007 in a crude oil price environment of approximately \$50 per barrel. Any significant and sustained decline in crude oil prices from that price may impact the feasibility of WesternZagros's business plan.

## **5. Critical accounting judgments, estimates and assumptions**

The preparation of these condensed consolidated interim financial statements in conformity with IFRS requires the use of critical accounting estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the reporting date, as well as the reported amounts of revenues and expenses during the reporting period. Such estimates relate to unsettled

transactions and events as at the reporting date. Accordingly, actual results may ultimately differ from the estimated amounts as future confirming events occur. Areas that involve a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the condensed consolidated interim financial statements are disclosed below.

#### **A. Recoverability of asset carrying values**

At each reporting date, the Company assesses its exploration and evaluation and property, plant and equipment expenditures for possible impairment if events or circumstances indicate the carrying values of the assets might not be recoverable. Relevant indicators include the following: the continued progression of Management's operational plans; new information obtained from wells that have been drilled or tested; changes or restrictions in access to drilling sites; changes in legal, regulatory, market, environmental, technological, or political factors that could impact ongoing operations; the ability of the Company to continue fulfilling ongoing commitments; and significant changes in the Company's market value.

If factors indicate that the Company may need to recognize impairment, the carrying value of the assets for each cash-generating-unit is compared to the greater of value-in-use or fair-value less costs to sell. The determination of the value-in-use amount, which is based on discounted future cash flows, and any resulting impairment involves the use of significant estimates and assumptions about future events and factors such as future commodity prices, the impact of inflation on operating expenses, discount rates, production profiles, the ability to produce and export crude oil and natural gas, the future capital costs needed to develop reserves, as well as the future marketability and availability of transportation for crude oil and natural gas that is produced.

At the reporting date, the Company is still in the exploration phase of operations on the Garmian and Kurdamir Blocks. The Company has not recognized any impairment for exploration and evaluation expenditures nor for property, plant, and equipment.

#### **B. Provision for decommissioning obligations**

The Company recognizes both an asset and a provision for decommissioning obligations in the period in which they are incurred by estimating the fair value of the obligation. The fair value calculations are based on a risk-free discount rate. Provisions for environmental clean-up and remediation costs associated with the Company's drilling operations are based on current legal and constructive requirements, technology, price levels and expected plans for remediation. Actual costs and cash outflows and the timing of those cash outflows can differ from estimates because of changes in laws and regulations, public expectations, prices, discovery and analysis of site conditions, future performance of wells drilled, and changes in clean-up technology. Estimating the timing and amount of cash outflows required to settle these obligations are inherently difficult and are based on Management's current experience. Any differences between actual and estimated decommissioning obligations would impact both the asset and the provision, which would then impact future depreciation of the asset as well as accretion on the provision.

### C. Income tax

Tax regulations and legislation and the interpretations thereof in the jurisdictions that the Company operates are subject to change. As such, income taxes are subject to measurement uncertainty. Deferred income tax assets are assessed by Management based on all available information at the end of the reporting period to determine the likelihood that they will be realized from future taxable earnings.

### D. Share-based payments

The estimates, assumptions, and judgments made in relation to the fair value of share-based payments and the associated expense recognition is subject to measurement uncertainty. The fair value of employee 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, expected life of the instrument, expected dividends, and the risk-free interest rate.

## 6. Segment reporting

The Company has only one significant asset related to its interest in the PSCs with the KRG in respect of an exploration project in the Kurdistan Region of Iraq. The Company is still in the exploration phase and has identified one segment for operational activities carried out in the country of Iraq. Also refer to Note 22 "Subsequent events, commitments and contingencies" for a description of the PSCs.

## 7. Cash and cash equivalents

	June 30, 2011	December 31, 2010	January 1, 2010
Bank balances	\$3,825	\$3,613	\$6,609
Term deposits	46,843	27,869	70,099
Cash and cash equivalents	\$50,668	\$31,482	\$ 76,708

## 8. Trade and other receivables

Current	June 30, 2011	December 31, 2010	January 1, 2010
Joint venture receivables	\$ 2,793	\$7,675	\$6,636
Other receivables	162	973	53
Loan receivable from related party	-	-	191
Total trade and other receivables	\$2,955	\$8,648	\$6,880

Joint venture receivables relate to amounts owing from Talisman for its working interest share of costs incurred in relation to the Original PSC agreement. Other receivables include a GST receivable as well as balances owing from certain payables vendors that have yet to be realized. The loan receivable at January 1, 2010 was in respect of a loan to a senior officer, this loan was fully repaid in the third quarter of 2010.

At the reporting date, there were joint venture receivables of \$0.2 million (December 31, 2010: \$0.2 million) that were more than ninety days past due but were not considered impaired. The other classes within trade and other receivables do not contain any impaired assets.

## 9. Exploration and evaluation expenditures

<b>As at</b>	<b>June 30, 2011</b>	<b>December 31, 2010</b>	<b>January 1, 2010</b>
Costs	\$211,992	\$180,770	\$ 154,097
Accumulated impairment	-	-	-
Net book value	\$211,992	\$180,770	\$ 154,097

<b>Period ended</b>	<b>Six months ended June 30, 2011</b>	<b>Twelve months ended December 31, 2010</b>
Opening net book value	\$180,770	\$ 154,097
Additions, net of insurance recoveries	31,683	26,673
Disposals	(461)	-
Impairment	-	-
Closing net book value	\$211,992	\$ 180,770

All exploration and evaluation expenditures pertain to the Kurdistan Region Exploration Project with respect to the Company's PSCs and have been capitalized in accordance with the Company's exploration and evaluation accounting policy. Included in exploration and evaluation expenditures as at June 30, 2011 is \$0.4 million related to provisions for decommissioning obligations (December 31, 2010: \$0.2 million). For the six months ended June 30, 2011, the Company has capitalized \$2.1 million of general and administrative costs (June 30, 2010: \$0.9 million), including \$0.3 million of share-based compensation costs (June 30, 2010: negligible amount) directly related to exploration activities. All exploration and evaluation expenditures are excluded from depreciation.

The Company initiated an insurance claim during 2010 related to the cost of the well control and recovery operations at Kurdamir-1. The control of well insurance policy covering these claims has a net aggregate limit to the Company of \$45 million, with a \$0.4 million deductible. Under the terms of the insurance policy, the Company submits claims for these costs as they are incurred and paid and these claims are then subject to the review and approval of an adjuster appointed by the insurers. As at June 30, 2011, the Company had received insurance proceeds of \$40.6 million related to approved interim claims. During the second quarter of 2011 the Company and insurers reached an agreement to settle the balance of the claim which brought the total amount credited for insurance recoveries to approximately \$45.0 million. Subsequent to June 30, 2011 the Company received the remaining \$4.4 million of insurance proceeds to conclude the claim. As at December 31, 2010, \$42.0 million had been credited for insurance recoveries.

As at June 30, 2011, the Company had approximately \$194 million relating to the Kurdamir and Garmian PSCs, net to WesternZagros, of recoverable costs available that may ultimately be recovered from future crude oil or natural gas sales in accordance with the PSCs (refer to Note 22 "Subsequent events, commitments and contingencies for a description of the PSCs). Under each PSC, costs subject to recovery include all costs and expenditures incurred for exploration, development, production and decommissioning operations, as well as any other costs and expenditures incurred directly or indirectly with these activities.

## 10. Property plant and equipment

As at the reporting date, property, plant and equipment is comprised of office and computer equipment and leasehold improvements. As the Company is still in the exploration stage all oil and gas assets, including assets related to provisions for decommissioning obligations, are classified within exploration and evaluation assets.

<b>As at</b>	<b>June 30, 2011</b>	<b>December 31, 2010</b>	<b>January 1, 2010</b>
Costs	\$1,830	\$1,830	\$ 1,830
Accumulated impairment	-	-	-
Accumulated depreciation	(1,670)	(1,569)	(1,016)
Net book value	\$160	\$261	\$ 814

<b>Period ended</b>	<b>Six months ended June 30, 2011</b>	<b>Twelve months ended December 31, 2010</b>
Opening net book value	\$261	\$ 814
Additions	-	-
Impairment	-	-
Depreciation	(101)	(553)
Closing net book value	\$160	\$ 261

## 11. Deposits held in trust

The Company had deposited in trust for a supplier amounts to be utilized to fund certain expenditures for drilling operations. During the first quarter of 2011 these funds held in trust were released back to the Company.

## 12. Income taxes

<b>For the six months ended June 30</b>	<b>2011</b>	<b>2010</b>
Current income tax recovery	\$(917)	\$ (904)
Future income tax expense (recovery)	37	109
Income tax expense (recovery)	\$880	\$ (795)

The deferred income tax asset is comprised of:

<b>Deferred income tax asset as at</b>	<b>June 30, 2011</b>	<b>December 31, 2010</b>	<b>January 1, 2010</b>
Share issue costs	\$162	\$204	\$408
Temporary differences on property, plant and equipment	4	(18)	(37)
Total deferred income tax asset	\$166	\$186	\$371

The deferred income tax liability is comprised of:

<b>Deferred income tax liability as at</b>	<b>June 30, 2011</b>	<b>December 31, 2010</b>	<b>January 1, 2010</b>
Temporary differences on property, plant and equipment	\$158	\$140	\$161
Non-capital loss carryforwards	-	-	(27)
Total deferred income tax liability	\$158	\$140	\$134

### **13. Trade and other payables**

<b>Current</b>	<b>June 30, 2011</b>	<b>December 31, 2010</b>	<b>January 1, 2010</b>
Trade payables	\$ 2,103	\$ 4,052	\$ 6,705
Accruals	11,531	17,473	11,592
<b>Total trade and other payables</b>	<b>\$13,634</b>	<b>\$21,525</b>	<b>\$18,297</b>

Trade payables are non-interest bearing and are normally settled on 30 to 60 day terms. Accruals relate mainly to exploration and evaluation expenditures incurred as at the reporting date.

### **14. Provision for decommissioning obligations**

Decommissioning liabilities are recognized when the Company has a present legal or constructive obligation as a result of past events, and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount of obligation can be made. Provisions are made for the present value of the future cost of abandonment of oil and gas wells and related facilities.

The amount recognized is the estimated cost of decommissioning activities based on internal engineering estimates prevailing at the reporting date, discounted to its present value utilizing a pre-tax risk-free interest rate. Changes in the estimated decommissioning costs or the estimated timing of decommissioning costs are dealt with prospectively by recording an adjustment to the provision, with a corresponding adjustment to exploration and evaluation assets, and are updated at each reporting date to reflect the current market assessments of the time value of money and the risks specific to the obligation.

These costs are expected to be incurred in the year 2035 in respect of well locations as at the reporting date. The Company's share of the total undiscounted amount of estimated cash flow required to settle the obligation is \$1.7 million. The Company has used the Bank of Canada long-term bond yield rate and an inflation rate of 4 percent to calculate the net present value of the future obligations. The additional obligation incurred in 2011 relates to the Company's current 100 percent working interest funding for the Sarqala-1 re-entry operation for which Talisman had elected not to participate (also refer to Note 22 "Subsequent events, commitments and contingencies").

The following table presents the reconciliation of the Company's provision for decommissioning liabilities:

	<b>Six months ended June 30, 2011</b>	<b>Twelve months ended December 31, 2010</b>
Balance, beginning of period	\$ 509	\$ 432
Additional obligations incurred	173	-
Changes in estimates or timing of cash flows	12	61
Accretion	12	16
<b>Balance, end of period</b>	<b>\$ 706</b>	<b>\$ 509</b>

### **15. Share capital**

As at June 30, 2011, the Company is authorized to issue an unlimited number of common shares and preferred shares, issuable in series. The common shares are without nominal or par value.

## 16. Share based payments

Pursuant to the stock option plan, the Board of Directors may grant options to directors, officers, employees and other service providers. The aggregate number of shares that may be reserved for issuance pursuant to stock options may not exceed 10 per cent of the issued and outstanding common shares of the Company on a non-diluted basis as at the time of granting. Stock options expire not more than five years from the date of grant, or earlier if the individual ceases to be associated with the Company, and the option vesting period is determined at the discretion of the Board of Directors when granted. These options are equity settled share based payment transactions.

The following tables present the reconciliation of stock options granted:

<b>For the year ended December 31, 2010</b>	Number of options	Weighted average exercise price (\$Cdn)
Outstanding, beginning of year	13,007,334	\$1.50
Granted	9,764,900	0.49
Exercised	-	-
Forfeited and expired	(2,417,334)	1.67
<b>Outstanding, end of year</b>	<b>20,354,900</b>	<b>\$1.00</b>
Exercisable at December 31, 2010	12,143,965	\$1.30

<b>For the six months ended June 30, 2011</b>	Number of Options	Weighted average exercise price (\$Cdn)
Outstanding, beginning of period	20,354,900	\$1.00
Granted	47,000	0.61
Exercised	(9,200)	0.49
Forfeited and expired	(807,667)	1.63
<b>Outstanding, end of period</b>	<b>19,585,033</b>	<b>\$0.97</b>
Exercisable at June 30, 2011	11,811,898	\$1.26

The fair value of all options granted have been estimated at the grant date using the Black-Scholes option pricing model and are summarized in the following table:

	Six months ended June 30, 2011	Twelve months ended December 31, 2010
Weighted average fair value of stock options granted	\$0.42	\$0.29
Average Risk Free Interest Rate	1.67%	1.62%
Expected Life	3 years	2 - 3 years
Average Expected Volatility	113%	120%
Dividend Per Share	Nil	Nil

During the six months ended June 30, 2011, the Company recognized \$0.4 million (2010: \$0.5 million) of stock based compensation as general and administrative expense and capitalized \$0.3 million (2010: negligible amount).

## **17. General and administrative expenses, by nature**

<b>For the six months ended June 30</b>	<b>2011</b>	<b>2010</b>
Staff expenses	\$3,040	\$2,381
Share-based payments	438	487
Travel expenses	439	224
Professional fees	495	918
Office costs	547	605
Regulatory and corporate project costs	246	240
Other administrative expenses	233	241
Less capitalized general and administrative costs	(1,795)	(1,850)
<b>Total administrative expenses</b>	<b>\$3,643</b>	<b>\$3,246</b>

Key management personnel have been identified as the Board of Directors and the Executive Management Team. Details of key management remuneration are shown in Note 18.

## **18. Related party transactions and balances**

All wholly-owned subsidiaries as listed in Note 3(c) have been included in the consolidated accounts.

The remuneration of the ten key management personnel of the Company, which includes the Directors and Officers and other Executive Management personnel, is set out below in aggregate:

<b>For the six months ended June 30</b>	<b>2011</b>	<b>2010</b>
Salaries and employee benefits	\$843	\$650
Share-based compensation expense	404	331
<b>Total</b>	<b>\$1,247</b>	<b>\$981</b>

## **19. Loss per share, basic and diluted**

The basic loss per share is calculated by dividing the loss attributable to shareholders of the Company by the weighted average number of common shares issued during the period. In computing diluted per share amounts, all of the Company's options at the reporting date totaling 19,585,033 (June 30, 2010 – 12,484,000) have been excluded as they are anti-dilutive. Accordingly no additional common shares were added to the basic weighted average shares outstanding to account for dilution.

The basic and diluted loss per share was calculated as follows:

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Loss for the period	\$1,416	\$1,646	\$2,896	\$2,979
Weighted-average common shares (000's)	297,130	207,464	263,444	207,464
<b>Loss per share (basic and diluted)</b>	<b>\$0.005</b>	<b>\$0.008</b>	<b>\$0.011</b>	<b>\$0.014</b>

## **20. Shareholder rights plan**

On October 18, 2007, the Corporation adopted a shareholder rights plan (the "Plan"). Under the Plan, one right has been issued in respect of each currently issued common share and one right will be issued with each additional common share which is issued. The rights remain attached to the common shares and are not

exercisable or separable unless one or more of certain specified events occur. If a person or group acting in concert acquires 20 per cent or more of the common shares of the Corporation, the rights will entitle the holders thereof (other than the acquiring person or group) to purchase common shares at a substantial discount from the then market price. The rights are not triggered by a "Permitted Bid" as defined in the Plan. The Plan will remain in effect until termination of the annual meeting of shareholders in 2013, unless extended by resolution of the shareholders at such meeting.

## 21. Supplemental cash flow information

Expenditures on exploration and evaluation assets are comprised of:

	For the three months ended June 30,		For the six months ended June 30,	
	2011	2010	2011	2010
Expenditures on exploration and evaluation assets	<b>\$(18,420)</b>	\$(15,962)	<b>\$(34,375)</b>	\$(29,115)
Change in non-cash investing working capital	<b>2,699</b>	67	<b>(375)</b>	(6,575)
	<b>\$(15,721)</b>	\$(15,895)	<b>\$(34,750)</b>	\$(35,690)

Changes in non-cash working capital is comprised of:

	For the three months ended June 30,		For the six months ended June 30,	
	2011	2010	2011	2010
<b>Related to operating activities</b>				
Trade and other receivables	<b>\$(1,716)</b>	\$51	<b>\$(1,278)</b>	\$(47)
Prepaid expenses	<b>74</b>	1	<b>(420)</b>	(212)
Trade and other payables	<b>(4)</b>	(4)	-	-
	<b>\$ (1,646)</b>	\$48	<b>\$(1,698)</b>	\$(259)
<b>Related to investing activities</b>				
Trade and other receivables	<b>\$637</b>	\$(1,230)	<b>7,391</b>	\$(3,137)
Trade and other payables	<b>2,062</b>	1,297	<b>(7,766)</b>	(3,438)
	<b>\$2,699</b>	\$67	<b>(375)</b>	\$(6,575)

## 22. Subsequent events, commitments and contingencies

### A. PSC commitments and subsequent events

Subsequent to June 30, 2011 the Company finalized an agreement with the Kurdistan Regional Government and Talisman to amend the original Production Sharing Contract (“Original PSC”) that governed the Company’s exploration activities in the Kalar-Bawanoor Block in Kurdistan. The agreement divides the contract area of the Original PSC into two contract areas named Garmian and Kurdamir (see chart below) and each will be operated under a distinct PSC.

WesternZagros will continue to operate the southern contract area named the Garmian Block that covers approximately 1,780 square kilometres and is now governed under the new Garmian PSC. The northern contract area is named the Kurdamir Block. It covers some 340 square kilometres and is now governed under an amended version of the Original PSC (the “Kurdamir PSC”). The northern area is now operated by Talisman. WesternZagros’s production sharing terms, under both the Garmian and Kurdamir PSCs, remain unchanged from the Original PSC.

A summary of the material amendments to the Original PSC is as follows:

	Original PSC (Kalar-Bawanoor)	Amended PSC (Kurdamir)	New PSC (Garmian)
First Exploration Sub-Period (expires)	December 31, 2010	June 30, 2012	December 31, 2011
Exploration Obligation (remaining)	Third Exploration Well	Kurdamir-2	Mil Qasim-1 Exploration Well
Second Exploration Sub-Period	Additional Two Years	Additional Two Years	Additional Two Years
Exploration Obligation	Two Exploration Wells	One Appraisal Well	One Exploration Well
Other Extensions	Two One Year Extensions	Six Month Extension	One Year Extension
Economic Terms	10% Royalty Oil, remainder available for Cost Recovery and Profit Oil	Unchanged	Unchanged
PSC Payments	\$ 5 Million Signature Bonus \$40 Million Capacity Building Support Payment \$ 1.1 Million Annual Payments	Additional Capacity Building Support Payment payable equal to 3% of WesternZagros Profit Oil. Continuation of previous annual payments.	Additional Capacity Building Support Payment payable equal to 3% of WesternZagros Profit Oil. Annual payments 50% of previous payments.
Operator	WesternZagros	Talisman	WesternZagros
Ownership	WesternZagros 40% Talisman 40% KRG 20% *	WesternZagros 40% Talisman 40% KRG 20% *	WesternZagros 40% Unassigned TPPI 40%** KRG 20% *
Contract Area	2,120 km2	340 km2	1,780 km2

\* WesternZagros funds 20% of the KRG costs. Ultimately to be recovered by WesternZagros through KRG’s share of Cost Recovery Oil.

\*\* WesternZagros initially funds the 40% of the costs for the third party participant interest until it is assigned by the KRG. The amounts funded by WesternZagros for the third party participant interest will be repaid upon assignment of this interest.

As at June 30, 2011, the Company estimates expenditures of approximately \$70 million, prior to the costs of any testing, to meet its remaining commitments for the first exploration sub-periods under the PSCs. This estimate includes the Company's current 100 percent funding requirement for the remaining costs associated with drilling the Mil Qasim-1 commitment well by December 31, 2011; the Company's 60 percent funding requirement of costs for drilling the Kurdamir-2 commitment well by June 30, 2012; the associated supervision and local office support costs related to both drilling operations; and the Company's annual funding requirements for certain technological, logistical, recruitment and training support under its PSCs.

## B. Other commitments

The Company has entered into and terminated various exploration-related contracts, including contracts for drilling equipment, services, tangibles and consulting service contracts. The following table summarizes the estimated commitments in relation to these exploration-related contracts relating to the PSCs and other contractual obligations at June 30, 2011:

	<b>For the Years Ending December 31,</b>					
	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015+</b>	<b>Total</b>
Exploration	\$4,462	\$5,500	-	-	-	\$9,962
Office	\$326	\$579	\$599	\$456	-	\$1,960
	<u>\$4,788</u>	<u>\$6,079</u>	<u>\$599</u>	<u>\$456</u>	<u>-</u>	<u>\$11,922</u>

## C. Consulting service contracts

In 2003 the Corporation entered into a consulting service contract that provided for a three percent right to participate indirectly in the future profits the Company may earn in respect to the Original PSC, in exchange for consulting services provided since that date. The contract has been terminated.

Further, in 2004 the Company entered into a consulting service contract that provided for a two percent right to participate indirectly in the future profits the Company may earn in respect to the Original PSC, in exchange for the provision of consulting services during the period 2004 to 2006. During the second quarter of 2011 the contract was terminated.

## **D. Contingencies**

### **i. Litigation**

From time to time the Company may become involved in legal or administrative proceedings in the normal conduct of business. Amounts involved in such matters are not reasonably estimable due to uncertainty as to the final outcome. The Company's assessment of the likely outcome of these matters is based on its judgment of a number of factors, including precedents and facts specific to the matters. The Company does not believe these matters, individually or in aggregate will have a material adverse effect on its consolidated financial position or consolidated comprehensive loss.

### **ii. Regulatory**

Oil and gas operations are subject to extensive controls and regulations imposed by various levels of government that may be amended from time to time. The Company's operations may require licenses and permits from various governmental authorities in the countries in which it operates. Under the Garmian and Kurdamir PSCs, the KRG is obligated to assist in obtaining all permits and licenses from any government agencies in the Kurdistan Region and from any other government administration in Iraq. There can be no assurance that the Company will be able to obtain all necessary licenses and permits that may be required to carry out exploration and development of its projects.

The political and security situation in Iraq is unsettled and volatile. The Kurdistan Region is the only "Region" of Iraq that is constitutionally established pursuant to the Iraq Constitution, which expressly recognizes the Kurdistan Region. The political issues of federalism and the autonomy of the Regions of Iraq are matters about which there are major differences between the various political factions in Iraq. These differences could adversely impact the Company's interest in the Kurdistan Region including the ability to export any hydrocarbons as a result of our activities.

## **23. Explanation of transition to IFRS**

These condensed consolidated interim financial statements present the Company's financial results of operations and financial position, prepared in accordance with IFRS, as at and for the three and six months ended June 30, 2011, in respect of the Company's first annual reporting date under IFRS of December 31, 2011. Previously the Company prepared its consolidated annual and consolidated interim financial statements in accordance with Canadian generally accepted accounting principles. In accordance with IFRS 1, First Time Adoption of IFRS, certain disclosures relating to the transition to IFRS are given in this note. These disclosures are prepared under IFRS as set out in the basis of preparation in Note 2.

IFRS 1 allows first time adopters of IFRS to utilize a number of voluntary exemptions from the general principal of retrospective restatement. The Company has utilized the following exemptions:

### **A. IFRS 3 Business combinations**

This standard has not been applied to acquisitions that occurred before January 1, 2010, the Company's transition date.

### **B. Full-cost book value as deemed costs**

In July 2009, the IASB published an amendment to IFRS 1, Additional Exemptions for First-Time Adopters, to allow a first time adopter that had previously utilized full-cost accounting for oil and gas activities under previous GAAP to elect to measure exploration and evaluation assets at the date of transition at the book value amount determined under the adopter's previous GAAP. The Company did follow a full cost approach under previous GAAP and has elected to utilize this exemption to measure exploration and evaluation expenditures on a deemed cost basis at the date of transition to IFRS.

**C. Reconciliation of equity from Canadian GAAP to IFRS as at the date of IFRS transition  
- January 1, 2010 (United States dollars thousands):**

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Assets</b>				
<b>Current assets</b>				
Cash and cash equivalents		\$76,708	\$ -	\$76,708
Trade and other receivables		6,880	-	6,880
Prepaid expenses		183	-	183
Income tax recoverable		1,738	-	1,738
Future income tax assets	a	231	(231)	-
<b>Total current assets</b>		<b>85,740</b>	<b>(231)</b>	<b>85,509</b>
<b>Non-current assets</b>				
Property, plant and equipment	b	154,911	(154,097)	814
Exploration and evaluation expenditures	b	-	154,097	154,097
Deposits held in trust		420	-	420
Deferred tax assets	a	6	365	371
<b>Total non-current assets</b>		<b>155,337</b>	<b>365</b>	<b>155,702</b>
<b>Total assets</b>		<b>\$241,077</b>	<b>\$134</b>	<b>\$241,211</b>
<b>Liabilities</b>				
<b>Current liabilities</b>				
Accounts payable and accrued liabilities		\$18,297	\$ -	\$18,297
<b>Total current liabilities</b>		<b>18,297</b>	<b>-</b>	<b>18,297</b>
<b>Non-current liabilities</b>				
Provision for decommissioning obligations	c	175	257	432
Deferred tax liabilities	a	-	134	134
<b>Total non-current liabilities</b>		<b>175</b>	<b>391</b>	<b>566</b>
<b>Total liabilities</b>		<b>18,472</b>	<b>391</b>	<b>18,863</b>
<b>Equity</b>				
Share capital		253,583	-	253,583
Contributed surplus	d	8,749	905	9,654
Deficit	e	(39,727)	(1,162)	(40,889)
<b>Total equity</b>		<b>222,605</b>	<b>(257)</b>	<b>222,348</b>
<b>Total equity and liabilities</b>		<b>\$241,077</b>	<b>\$134</b>	<b>\$241,211</b>

**Explanation of the effect of transition to IFRS (United States dollars thousands):**

- a. Reclassification of the current portion of future income tax assets recognized under previous GAAP to non-current assets in accordance with IAS 12, Income Taxes. **Net effect was a decrease in current future income tax assets of \$0.2 million.** In addition, the presentation of net deferred tax assets and liabilities are based on a separate legal entity basis which resulted in **a net increase of \$0.4 million in deferred tax assets and an increase of \$0.1 million in deferred tax liabilities.** The net overall change to deferred taxes was NIL.

- b. Reclassification of exploration and evaluation expenditures previously classified as property, plant and equipment under previous GAAP in accordance with IFRS 1, First Time Adoption of IFRS. The Company utilized the exemption under IFRS 1 that allows entities following a full-cost approach under previous GAAP to recognize exploration and evaluation assets on a deemed cost basis upon transition to IFRS. **Net effect was a decrease in property, plant and equipment of \$154.1 million with a corresponding increase in exploration and evaluation assets.**
- c. Upon adoption of IAS 37, Provisions, Contingent Liabilities, and Contingent Assets, the provision for decommissioning obligations (previously referred to as “asset retirement obligation”) was increased due to a change in the discount rate utilized for the present value calculation of these obligations. Under previous GAAP a credit adjusted risk-free rate was utilized, but under IFRS a non-credit adjusted risk-free rate is utilized in the valuation of the discounted cash flows associated with estimated future abandonment costs. **Net effect was an increase in the provision for decommissioning liabilities of \$0.3 million**, with a corresponding increase in the accumulated deficit.
- d. Upon adoption of IFRS 2, Share Based Payments, the expense relating to options granted to employees was recognized over the vesting period for each individual vesting tranche, as opposed to previous GAAP which recognized the expense on a straight-line basis over the total vesting period of the entire grant. Upon transition to IFRS this resulted in an accelerated recognition of the expense associated with share-based payments, but was partially offset by a reduction in expense due to estimated forfeitures associated with unvested options not previously estimated under GAAP. **Net effect was an increase in contributed surplus of \$0.9 million**, with a corresponding increase in the accumulated deficit.
- e. The cumulative effect of these transition adjustments on the accumulated deficit as at the date of transition to IFRS is based on the combination of items (c) and (d). **The net effect was an increase in the accumulated deficit of \$1.2 million.**

**D. Reconciliation of equity from Canadian GAAP to IFRS as at the end of the prior year comparative interim period – June 30, 2010 (United States dollars thousands):**

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Assets</b>				
<b>Current assets</b>				
Cash and cash equivalents		\$43,769	\$ -	\$43,769
Trade and other receivables		8,565	-	8,565
Insurance recoveries receivable	a	14,307	(10,053)	4,254
Prepaid expenses		395	-	395
Income tax recoverable		2,044	-	2,044
Future income tax assets	b	153	(153)	-
<b>Total current assets</b>		<b>69,233</b>	<b>(10,206)</b>	<b>59,027</b>
<b>Non-current assets</b>				
Property, plant and equipment	c	166,353	(165,850)	503
Exploration and evaluation expenditures	c	-	175,079	175,079
Deposits held in trust		420	-	420
Deferred income tax assets	b	-	266	266
<b>Total non-current assets</b>		<b>166,773</b>	<b>9,495</b>	<b>176,268</b>
<b>Total assets</b>		<b>\$236,006</b>	<b>\$(711)</b>	<b>\$235,295</b>
<b>Liabilities</b>				
<b>Current liabilities</b>				
Accounts payable and accrued liabilities		\$14,860	\$ -	\$14,860
<b>Total current liabilities</b>		<b>14,860</b>	<b>-</b>	<b>14,860</b>
<b>Non-current liabilities</b>				
Provision for decommissioning obligations	d	182	304	486
Deferred tax liabilities	b	25	113	138
<b>Total non-current liabilities</b>		<b>207</b>	<b>417</b>	<b>624</b>
<b>Total liabilities</b>		<b>15,067</b>	<b>417</b>	<b>15,484</b>
<b>Equity</b>				
Share capital		253,583	-	253,583
Contributed surplus	e	9,809	287	10,096
Deficit	f	(42,453)	(1,415)	(43,868)
<b>Total equity</b>		<b>220,939</b>	<b>(1,128)</b>	<b>219,811</b>
<b>Total equity and liabilities</b>		<b>\$236,006</b>	<b>\$(711)</b>	<b>\$235,295</b>

**Explanation of the effect of transition to IFRS (United States dollars thousands):**

- Upon transition to IFRS, an adjustment was required for the timing of recognition related to the insurance recoveries receivable. Under IFRS receivables could only be recognized to the extent that they were “virtually certain” to be realized. Virtual certainty was defined as the point in time the adjuster approved the interim claims, rather than Management’s estimate of the receivable as calculated under previous GAAP. The resulting adjustment as at June 30, 2010 was a **decrease in the insurance recoveries receivable of \$10.1 million**. Note that the total insurance recoveries for year ended December 31, 2010 were unchanged.
- Reclassification of the current portion of future income tax assets recognized under previous GAAP to non-current assets in accordance with IAS 12, Income Taxes. **Net effect is a decrease in current future income**

**tax assets of \$0.2 million.** In addition, the presentation of net deferred tax assets and liabilities are based on a separate legal entity basis which resulted in a **net increase of \$0.3 million in deferred tax assets** and an **increase of \$0.1 million in deferred tax liabilities.** The net overall change to deferred taxes was NIL.

- c. Adjustments to property, plant and equipment as well as exploration and evaluation expenditures were as follows:
- i. Exploration and evaluation expenditures previously classified as property, plant and equipment under GAAP were reclassified in accordance with IFRS 1, First Time Adoption of IFRS. The Company utilized the IFRS 1 exemption allowing entities following a full-cost approach under previous GAAP to recognize exploration and evaluation assets on a deemed cost basis upon transition to IFRS. In addition, exploration and evaluation expenditures incurred during the six months ended June 30, 2010 were also reclassified in accordance with IFRS 6, Exploration for and Evaluation of Mineral Resources. **The net effect was a decrease in property, plant and equipment of \$165.9 million with an associated increase in exploration and evaluation expenditures of \$165.9million.**
  - ii. Certain corporate projects that were previously capitalized within the full cost pool as allowed under previous Canadian GAAP, but which were unrelated to the Company's PSC contract areas, have been expensed as part of General and administrative costs for the six months ended June 30, 2010 after conversion to IFRS. **The net effect was a decrease in exploration and evaluation expenditures of \$0.3 million.**
  - iii. Share-based payment amounts associated with employees that directly contribute to exploration and evaluation activities are recognized as part of exploration and evaluation expenditures. Upon adoption of IFRS 2, Share Based Payments, the expense relating to options granted to those employees is recognized over the vesting period for each individual vesting tranche, as opposed to previous GAAP which recognized the expense on a straight-line basis over the total vesting period of the entire grant. The net effect of the change in the timing of recognition of share-based payments associated with those employees that directly contributed to exploration and evaluation activities during the six months ended June 30, 2010 resulted in a **decrease in exploration and evaluation expenditures of \$0.6 million.**
  - iv. Upon adoption of IAS 37, Provisions, Contingent Liabilities, and Contingent Assets, the provision for decommissioning obligations (previously referred to as "asset retirement obligation") is prospectively adjusted each period for any changes in the estimated future decommissioning expenditures or the timing of estimated future decommissioning expenditures. Changes to estimates during the six months ended June 30, 2010 resulted in an overall increase in the provision for decommissioning obligations of \$0.05 million. Accordingly, **the net effect was negligible for exploration and evaluation expenditures.**
  - v. The corresponding impact of item (a) above related to the change in timing for recognition of insurance recoveries credits resulted in **an increase of \$10.1 million for exploration and evaluation expenditures.**
  - vi. **The total net impact of items (i) through (v) was an increase in exploration and evaluation assets of \$175.1 million.**
- d. Upon adoption of IAS 37, Provisions, Contingent Liabilities, and Contingent Assets, the provision for decommissioning obligations (previously referred to as "asset retirement obligation") increased due to a change in the discount rate utilized for the present value calculation of these obligations upon conversion to IFRS. Under previous GAAP a credit adjusted risk-free rate was utilized, but under IFRS a non-credit adjusted risk-free rate is utilized in the valuation of the discounted cash flows associated with estimated future abandonment costs. In addition, during the six months ended June 30, 2010, the provision for decommissioning obligations was also adjusted prospectively each period for changes in the estimated future decommissioning expenditures or the timing of estimated future decommissioning expenditures. **The total net effect of these changes was an increase in the provision for decommissioning obligations of \$0.3 million.**
- e. Upon adoption of IFRS 2, Share Based Payments, the expense relating to options granted to employees is recognized over the vesting period for each individual vesting tranche, as opposed to previous GAAP which recognized the expense on a straight-line basis over the total vesting period of the entire grant. Upon transition to IFRS this resulted in an accelerated recognition of the expense associated with share-based

payments, but was partially offset by a reduction in expense associated with estimated forfeitures associated with unvested options which were not estimated under previous GAAP. **The net effect at June 30, 2010 was an increase in contributed surplus of \$0.3 million.**

- f. The cumulative change in the accumulated deficit is summarized as follows:
- i. Impact of increased provision for decommissioning obligation at January 1, 2010 was an increase in accumulated deficit of \$0.3 million.
  - ii. Impact of increased contributed surplus related to share based payments at January 1, 2010 was an increase in accumulated deficit of \$0.9 million.
  - iii. Impact of expensing certain Corporate projects that had been capitalized under previous GAAP during the six months ended June 30, 2010 was an increase in the accumulated deficit of \$0.3 million.
  - iv. **The total impact of items (i) through (iii) was an increase in the accumulated deficit of \$1.4 million as at June 30, 2010,** including other minor adjustments of \$(0.1) million.

**E. Reconciliation of equity from Canadian GAAP to IFRS as at the end of the last reporting year under Canadian GAAP – December 31, 2010 (United States dollars thousands):**

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Assets</b>				
<b>Current assets</b>				
Cash and cash equivalents		\$31,482	\$ -	\$31,482
Trade and other receivables		8,648	-	8,648
Insurance recoveries receivable		17,597	-	17,597
Deposits held in trust		420	-	420
Prepaid expenses		39	-	39
Income tax recoverable		887	-	887
Future income tax assets	a	102	(102)	-
<b>Total current assets</b>		<b>59,175</b>	<b>(102)</b>	<b>59,073</b>
<b>Non-current assets</b>				
Property, plant and equipment	b	182,056	(181,795)	261
Exploration and evaluation expenditures	b	-	180,770	180,770
Future income tax assets	a	-	186	186
<b>Total non-current assets</b>		<b>182,056</b>	<b>(839)</b>	<b>181,217</b>
<b>Total assets</b>		<b>\$241,231</b>	<b>\$ (941)</b>	<b>\$240,290</b>
<b>Liabilities</b>				
<b>Current liabilities</b>				
Accounts payable and accrued liabilities		\$21,525	\$ -	\$21,525
<b>Total current liabilities</b>		<b>21,525</b>	<b>-</b>	<b>21,525</b>
<b>Non-current liabilities</b>				
Provision for decommissioning obligations	c	189	320	509
Deferred tax liabilities		56	84	140
<b>Total non-current liabilities</b>		<b>245</b>	<b>404</b>	<b>649</b>
<b>Total liabilities</b>		<b>21,770</b>	<b>404</b>	<b>22,174</b>
<b>Equity</b>				
Share capital		253,583	-	253,583
Contributed surplus	d	11,353	(130)	11,223
Deficit	e	(45,475)	(1,215)	(46,690)
<b>Total equity</b>		<b>219,461</b>	<b>(1,345)</b>	<b>218,116</b>
<b>Total equity and liabilities</b>		<b>\$241,231</b>	<b>\$(941)</b>	<b>\$240,290</b>

**Explanation of the effect of transition to IFRS (United States dollars thousands):**

- a. Reclassification of the current portion of future income tax assets recognized under previous GAAP to non-current assets in accordance with IAS 12, Income Taxes. **Net effect is a decrease in current future income tax assets of \$0.1 million.** In addition, the presentation of net deferred tax assets and liabilities are based on a separate legal entity basis which resulted in a **net increase of \$0.2 million in deferred tax assets** and an **increase of \$0.1 million in deferred tax liabilities.** The net overall change to deferred taxes was NIL.
- b. Adjustments to property, plant, and equipment as well as exploration and evaluation expenditures were as follows:

- i. Exploration and evaluation expenditures previously classified as property, plant and equipment under GAAP were reclassified in accordance with IFRS 1, First Time Adoption of IFRS. The Company utilized the IFRS 1 exemption allowing entities following a full-cost approach under previous GAAP to recognize exploration and evaluation assets on a deemed cost basis upon transition to IFRS. In addition, exploration and evaluation expenditures incurred during the year ended December 31, 2010 were also reclassified in accordance with IFRS 6, Exploration for and Evaluation of Mineral Resources. **The net effect was a decrease in property, plant and equipment of \$181.8 million and an associated increase in exploration and evaluation expenditures of \$181.8 million.**
  - ii. Certain corporate projects that were previously capitalized within the full cost pool as allowed under previous Canadian GAAP, but which were unrelated to the Company's PSC contract areas, have been expensed as part of General and administrative costs for the year ended December 31, 2010. **The net effect was a decrease in exploration and evaluation expenditures of \$0.3 million.**
  - iii. Share-based payment amounts associated with employees that directly contribute to exploration and evaluation activities are recognized as part of intangible exploration and evaluation expenditures. Upon adoption of IFRS 2, Share Based Payments, the expense relating to options granted to those employees is recognized over the vesting period for each individual vesting tranche, as opposed to previous GAAP which recognized the expense on a straight-line basis over the total vesting period of the entire grant. **The net effect of the change in the timing of recognition of share-based payments associated with those employees that directly contributed to exploration and evaluation activities during the year ended December 31, 2010 resulted in a decrease in exploration and evaluation expenditures of \$0.8 million.**
  - iv. Upon adoption of IAS 37, Provisions, Contingent Liabilities, and Contingent Assets, the provision for decommissioning obligations (previously referred to as "asset retirement obligation") is prospectively adjusted each period for changes in the estimated future decommissioning expenditures or the timing of estimated future decommissioning expenditures. Changes to estimates during the year ended December 31, 2010 resulted in an overall increase in the provision for decommissioning obligations of \$0.1 million. **The net effect was a corresponding increase in exploration and evaluation expenditures of \$0.1 million.**
  - v. **The total net impact of items (i) through (iv) was an increase in exploration and evaluation assets of \$180.8 million.**
- c. Upon adoption of IAS 37, Provisions, Contingent Liabilities, and Contingent Assets, the provision for decommissioning obligations (previously referred to as "asset retirement obligation") increased due to a change in the discount rate utilized for the present value calculation of these obligations upon conversion to IFRS. Under previous GAAP a credit adjusted risk-free rate was utilized, but under IFRS a non-credit adjusted risk-free rate is utilized in the valuation of the discounted cash flows associated with estimated future abandonment costs. In addition, during the year ended December 31, 2010, the provision for decommissioning obligations was also adjusted prospectively each period for changes in the estimated future decommissioning expenditures or the timing of estimated future decommissioning expenditures. **The total net effect of these changes was an increase in the provision for decommissioning obligations of \$0.3 million.**
- d. Upon adoption of IFRS 2, Share Based Payments, the expense relating to options granted to employees is recognized over the vesting period for each individual vesting tranche, as opposed to previous GAAP which recognized the expense on a straight-line basis over the total vesting period of the entire grant. Upon transition to IFRS this resulted in an accelerated recognition of the expense associated with share-based payments in prior periods and resulted in less expense recognition during 2010. In addition, the expense associated with share based payments was slightly reduced due to estimated forfeitures associated with unvested options that had not been estimated under previous GAAP. **The net effect at December 31, 2010 was a reduction in contributed surplus of \$0.1 million.**

- e. The cumulative change in the accumulated deficit is summarized as follows:
- i. Impact of increased provision for decommissioning obligation at January 1, 2010 was an increase in accumulated deficit of \$0.3 million.
  - ii. Impact of increased contributed surplus related to share based payments at January 1, 2010 was an increase in accumulated deficit of \$0.9 million.
  - iii. Impact from expensed portion of share based payments during the year ended December 31, 2010 was a decrease in accumulated deficit of \$0.3 million.
  - iv. Impact from increased accretion expense associated with decommissioning liabilities for the year ended December 31, 2010 was NIL.
  - v. Impact of expensing certain Corporate projects that had been capitalized under previous GAAP during the year ended December 31, 2010 was an increase in the accumulated deficit of \$0.3 million.
  - vi. **The total impact of all of items (i) through (v) was an increase in the accumulated deficit of \$1.2 million.**

**F. Reconciliation of comprehensive loss from Canadian GAAP to IFRS for the six months ended June 30, 2010 (United States dollars thousands):**

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Revenue</b>				
Interest income		\$ 36	\$ -	\$ 36
<b>Expenses</b>				
General and administrative expenses	a	2,994	252	3,246
Depreciation		311	-	311
Accretion on decommissioning liabilities		7	1	8
Foreign exchange loss		245	-	245
Total expenses		3,557	253	3,810
<b>Loss before taxation</b>		3,521	253	3,774
<b>Taxation</b>				
Current		(904)	-	(904)
Deferred		109	-	109
Total taxation (recovery)		(795)	-	(795)
<b>Comprehensive loss for the period attributable to shareholders</b>		\$2,726	\$253	\$2,979

**Explanation of the effect of transition to IFRS (United States dollars thousands):**

- a. Adjustments to general and administrative expenses were mainly comprised of certain corporate projects that were previously capitalized within the full cost pool as allowed under previous Canadian GAAP, but which were unrelated to the Company's PSC contract areas, which have been expensed as part of general and administrative costs for the six months ended June 30, 2010 after conversion to IFRS. **The net effect was an increase in general and administrative costs of \$0.3 million.**

Also note that the net adjustment for stock-based compensation expense as at June 30, 2010 was not material.

**G. Reconciliation of comprehensive loss from Canadian GAAP to IFRS for the year ended December 31, 2010 (United States dollars thousands):**

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Revenue</b>				
Interest income		\$ 87	\$ -	\$ 87
<b>Expenses</b>				
General and administrative expenses	a	6,362	51	6,413
Depreciation		553	-	553
Accretion on decommissioning liabilities		14	2	16
Foreign exchange loss		62	-	62
Total expenses	a	6,991	53	7,044
<b>Loss before taxation</b>		6,904	53	6,957
<b>Taxation</b>				
Current		(1,347)	-	(1,347)
Deferred		191	-	191
Total taxation (recovery)		(1,156)	-	(1,156)
<b>Comprehensive loss for the period attributable to shareholders</b>		\$5,748	\$53	\$5,801

**Explanation of the effect of transition to IFRS (United States dollars thousands):**

- a. Adjustments to general and administrative expenses were as follows:
- i. Certain corporate projects that were previously capitalized within the full cost pool as allowed under previous Canadian GAAP, but which were unrelated to the Company's PSC contract areas, have been expensed as part of general and administrative costs for the year ended December 31, 2010 after conversion to IFRS. **The net effect was an increase in general and administrative costs of \$0.3 million.**
  - ii. Share-based payment amounts associated with employees that do not directly contribute to exploration and evaluation activities are recognized as part of general and administrative expenses. Upon adoption of IFRS 2, Share Based Payments, the expense relating to options granted to those employees is recognized over the vesting period for each individual vesting tranche, as opposed to previous GAAP which recognized the expense on a straight-line basis over the total vesting period of the entire grant. **The net effect of the change in the timing of recognition of share-based payments associated with employee's activities during the year ended December 31, 2010 resulted in a decrease in general and administrative expenses of \$0.3 million.**
  - iii. **The total net impact of items (i) and (ii) was an increased net loss of \$0.1 million, including a \$2k adjustment to accretion.**

**H. Reconciliation of statement of cash flows from Canadian GAAP to IFRS for the six months ended June 30, 2010 (United States dollars thousands):**

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Cash flow from operating activities</b>				
Net loss prior to taxation	a	\$ (2,726)	\$(1,048)	\$ (3,774)
Adjustments for				
Depreciation		311	-	311
Accretion on decommissioning liabilities		7	1	8
Share based payments		495	(8)	487
Income tax recovered (paid)	b	-	598	598
Future income tax expense	c	109	(109)	-
Change in non-cash working capital	d	(565)	306	(259)
Net cash from (used in) operating activities		(2,369)	(260)	(2,629)
<b>Cash flow from investing activities</b>				
Expenditure on exploration and evaluation assets	e	-	(35,690)	(35,690)
Expenditure on property, plant, and equipment	f	(29,375)	29,375	-
Insurance recoveries		5,380	-	5,380
Change in non-cash working capital	e	(6,575)	6,575	-
Net cash from (used in) investing activities		(30,570)	260	(30,310)
<b>Cash flow from financing activities</b>				
None		-	-	-
Net cash from (used in) financing activities		-	-	-
<b>Change in cash and cash equivalents</b>				
		(32,939)	-	(32,939)
Cash and cash equivalents, beginning of period		76,708	-	76,708
<b>Cash and cash equivalents, end of period</b>		<b>\$ 43,769</b>	<b>-</b>	<b>\$ 43,769</b>

**Explanation of the effect of transition to IFRS (United States dollars thousands):**

- a. Adjustments to net loss, which total to \$(1.0 million), were as follows:
  - i. Presentation of net loss under IFRS is prior to taxation expense. The net effect was an increased net loss prior to total taxation expense (current and deferred) of \$0.8 million.
  - ii. Increased general and administrative expense for corporate projects previously capitalized under IFRS, the net effect was an increased net loss of \$0.3 million.
  - iii. **Total net effect of items (i) through (ii) is an increased net loss of \$1.0 million**, including other minor adjustments that reduced the net loss by \$0.1 million.
- b. **Increased \$0.6 million due to presentation of actual taxes recovered under IFRS.**
- c. Presentation of net loss under IFRS is prior to taxation, accordingly there is no adjustment for future income tax expense, **net effect was a reduction of the adjusting item to zero.**
- d. Adjustments to change in non-cash working capital were as follows:

- i. Presentation of net loss under IFRS is prior to taxation, as a result the change in current income tax recovery is removed from the change in non-cash working capital which results in an increase in the change in non-cash working capital for operating activities of \$0.9 million.
  - ii. In addition, actual taxes recovered are reflected separately, which results in a \$0.6 million decrease to the change in non-cash working capital for operating activities.
  - iii. **The net effect of items (i) and (ii) resulted in an increase in the net change for non-cash working capital items of \$0.3 million.**
- e. The net change in exploration and evaluation expenditures is as follows:
  - i. Reclassification of expenditures on property, plant and equipment of \$29.4 million.
  - ii. Decrease in expenditures of \$0.3 million for corporate projects previously capitalized under GAAP that were expensed as general and administrative expenses under IFRS.
  - iii. Combine changes in non-cash investing working capital with E&E expenditures for proper presentation under IFRS, which **reduces the change in non-cash working capital to NIL.**
  - iv. **The net effect of items (i) through (iii) results in an increase in exploration and evaluation expenditures of \$35.7 million.**
- f. **Expenditures for property, plant and equipment were reclassified as exploration and evaluation expenditures, net effect was a decrease of \$29.4 million.**

**I. Reconciliation of statement of cash flows from Canadian GAAP to IFRS for the year ended December 31, 2010 (United States dollars thousands):**

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Cash flow from operating activities</b>				
Net loss prior to taxation	a	\$ (5,748)	\$(1,209)	\$ (6,957)
Adjustments for				
Depreciation		553	-	553
Accretion on decommissioning liabilities		14	2	16
Share based payments	b	1,568	(258)	1,310
Income tax recovered (paid)	c	-	2,198	2,198
Future income tax expense	d	191	(191)	-
Change in non-cash working capital	e	728	(851)	(123)
Net cash from (used in) operating activities		(2,694)	(309)	(3,003)
<b>Cash flow from investing activities</b>				
Expenditure on exploration and evaluation assets	f	-	(66,626)	(66,626)
Expenditure on property, plant, and equipment	g	(67,162)	67,162	-
Insurance recoveries		24,403	-	24,403
Change in non-cash working capital	f	227	(227)	-
Net cash from (used in) investing activities		(42,532)	309	(42,223)
<b>Cash flow from financing activities</b>				
None		-	-	-
Net cash from (used in) financing activities		-	-	-
<b>Change in cash and cash equivalents</b>				
		(45,226)	-	(45,226)
Cash and cash equivalents, beginning of period		76,708	-	76,708
<b>Cash and cash equivalents, end of period</b>		<b>\$ 31,482</b>	<b>-</b>	<b>\$ 31,482</b>

**Explanation of the effect of transition to IFRS (United States dollars thousands):**

- a. Adjustments to net loss, which total to \$(1.2 million), were as follows:
  - i. Presentation of net loss under IFRS is prior to total taxation (current and deferred). The net effect was an increased net loss prior to taxation of \$1.2 million.
  - ii. Decreased expense associated with share-based payments, net effect was a decreased net loss of \$0.3 million.
  - iii. Increased general and administrative expense for corporate projects previously capitalized under IFRS, the net effect was an increased net loss of \$0.3 million.
  - iv. **Total net effect of items (i) through (iii) is an increased net loss of \$1.2 million.**
- b. **Decreased expense relating to timing of recognition of share based payment under IFRS 2, net effect a decrease of \$0.3 million.**
- c. **For proper presentation under, actual taxes recovered of \$2.2 million are reflected directly in the cash flow statement.**

- d. Presentation of net loss under IFRS is prior to taxation, accordingly there is no adjustment for future income tax expense, **net effect was a reduction of the adjusting item to zero.**
- e. Adjustments to change in non-cash working capital were as follows:
  - i. Presentation of net loss under IFRS is prior to taxation, as a result the change in current income tax recovery is removed from the change in non-cash working capital which results in an increase in the change in non-cash working capital for operating activities of \$1.3 million.
  - ii. In addition, actual taxes recovered are reflected separately, which results in a \$2.2 million decrease to the change in non-cash working capital for operating activities.
  - iii. The net effect of items (i) and (ii) resulted in a **decrease in the net change for non-cash working capital items of \$0.9 million.**
- f. The net change in exploration and evaluation expenditures is as follows:
  - i. Reclassification of expenditures on property, plant and equipment of \$67.2 million.
  - ii. Decrease in expenditures of \$0.3 million for corporate projects previously capitalized under GAAP that were expensed as general and administrative expenses under IFRS.
  - iii. Combine changes in non-cash investing working capital with E&E expenditures for proper presentation under IFRS, which **reduces the change in non-cash working capital to NIL.**
  - iv. **The net effect of items (i) through (iii) results in an increase in exploration and evaluation expenditures of \$66.6 million.**
- g. **Expenditures for property, plant and equipment were reclassified as exploration and evaluation expenditures, net effect was a decrease of \$67.2 million.**

## Corporate Information

<p><b>Officers</b></p> <p><b>M. Simon Hatfield</b> Chief Executive Officer</p> <p><b>Greg Stevenson</b> Chief Financial Officer</p> <p><b>Lianne Tysowski</b> Corporate Secretary</p> <p><b>Directors</b></p> <p><b>David Boone</b> President &amp; CEO Barrick Energy Inc. Calgary, Alberta</p> <p><b>Fred Dymont</b> Chairman WesternZagros Resources Ltd. Calgary, Alberta</p> <p><b>John Frangos</b> Independent Businessman Calgary, Alberta</p> <p><b>M. Simon Hatfield</b> Chief Executive Officer WesternZagros Resources Ltd. Calgary, Alberta</p> <p><b>James Houck</b> President and Chief Executive Officer The Churchill Corporation Calgary, Alberta</p> <p><b>Randall Oliphant</b> Executive Chairman and Director New Gold Inc. Toronto, Ontario</p> <p><b>William Wallace</b> Independent Businessman Glenwood Springs, Colorado</p>	<p><b>Head Office</b></p> <p>WesternZagros Resources Ltd. Suite 600, 440 – 2nd Ave. S.W. Calgary, Alberta T2P 5E9 Phone: (403) 693-7001 Fax: (403) 233-0174 Website www.westernzagros.com</p> <p><b>Auditors</b></p> <p>PricewaterhouseCoopers LLP Calgary, Alberta</p> <p><b>Resource Evaluators</b></p> <p>Sproule International Limited Calgary, Alberta</p> <p><b>Legal Counsel</b></p> <p>Macleod Dixon LLP Calgary, Alberta</p> <p>King &amp; Spalding LLP Houston, Texas</p> <p><b>Transfer Agent And Registrar</b></p> <p>Valiant Trust Company Calgary, Alberta</p> <p><b>Stock Exchange Listing</b></p> <p>TSX Venture Exchange Common Shares: WZR</p>
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