

WesternZagros Resources Ltd.

# Q3 2011

Third Quarter Interim Report  
for the periods ended September 30, 2011

## Message to Shareholders

**Calgary, Alberta – Monday, November 21, 2011** –WesternZagros Resources Ltd. (TSX-V – WZR) ("WesternZagros" or "the Company") provides its results for the periods ended September 30, 2011, key highlights, and activities to date.

In September 2011, WesternZagros received approval from the Ministry of Natural Resources of the Kurdistan Regional Government to start an extended well test at Sarqala. First oil production from Sarqala-1 was achieved on October 18, 2011, after the necessary construction and commissioning activities for the initial facilities were completed. Production started at approximately 2,000 barrels of oil per day ("bopd") and the Company is planning to achieve production from Sarqala-1 of approximately 5,000 bopd by the end of 2011. In the first half of 2011, the Sarqala-1 well initially tested 40°API crude oil at rates of over 9,000 bopd and at a wellhead pressure of approximately 2,400 pounds per square inch. The well was not stimulated and is expected to improve production rate capability during the extended well test. WesternZagros will utilize the information gathered from the extended well test in determining future appraisal and development activities, including the potential for increasing production beyond 5,000 bopd.

On October 27, 2011, WesternZagros sold its first oil produced from Sarqala-1 into the domestic market. To date, for the sales into the domestic market WesternZagros has executed two sales contracts for total delivery of approximately 66,500 barrels of oil priced in the range of \$50 to \$60 per barrel, and under the terms of these sales contracts WesternZagros received payments totaling \$3.8 million in advance of delivery for these sales. Deliveries under these sales agreements to November 17, 2011 have totalled approximately 47,000 barrels of oil.

On October 25, 2011, WesternZagros closed a strategic investment with the Abu Dhabi National Energy Company PJSC ("TAQA") whereby TAQA purchased from WesternZagros, through a private placement, 74 million common shares of the Company at a price of Cdn\$0.63 per share for gross proceeds of Cdn\$46,620,000. TAQA now holds approximately 19.9 percent of the Company's issued and outstanding common shares. The proceeds from the private placement will be used towards WesternZagros's 2011/2012 capital and operating program.

On August 29, 2011, WesternZagros commenced drilling operations at the Mil Qasim-1 well on the Garmian Block. Mil Qasim-1 is located three kilometres to the south-east of the Company's Sarqala-1 discovery well and is targeting the prospective Upper Fars interval. After successfully setting the 13-5/8 inch casing at 1,615 metres in Mil Qasim-1, the Company has drilled into the Upper Fars interval and has encountered over 88 metres of sands in the Upper Fars and had hydrocarbon shows, both oil and gas, while drilling. WesternZagros has completed logging these initial sands in the Upper Fars, set the 9-5/8 inch casing at 2,128 metres and is preparing to complete drilling to the estimated total depth of Mil Qasim-1 of 2,400 metres. Once total depth is reached, WesternZagros plans to conduct a testing program of the Upper Fars interval.

On October 25, 2011, the Kurdamir-2 exploration well commenced drilling operations, with expected completion by June 2012. The well is being drilled on the flank of the Kurdamir structure approximately two kilometres from the Kurdamir-1 discovery well. Kurdamir-2 is targeting the prospective Oligocene, Eocene and Cretaceous reservoirs. Talisman (Block K44) B.V. ("Talisman") is the operator of the Kurdamir-2 well. To date Kurdamir-2 has been drilled to a depth of approximately 700 metres, where the first intermediate string of casing has been set. WesternZagros anticipates that the drilling and testing of the first reservoir, the Oligocene reservoir, will occur in

the first quarter of 2012, with the deeper reservoirs, the Eocene and Cretaceous reservoirs, expected to be drilled and tested by the end of the second quarter of 2012.

During the third quarter of 2011, WesternZagros updated its contingent and prospective resource estimates to reflect the discovery in the Jeribe reservoir at Sarqala-1 and the additional prospects and plays identified on the Garmian Block (Tilako, Zardi, Segrdan, Chwar and Alyan prospects, the Upper Fars Fault Trap Play and the Upper Fars Bawanoor Saddle Play). These updates of contingent and prospective resource estimates were audited by Sproule International Limited. The Company's mean estimate of gross contingent resources for the discovery at Sarqala-1 is 24 million barrels (MMbbl) of oil, or 31 million barrels of oil equivalent (MMBOE), as of September 7, 2011. This contingent resource number does not include the significant prospective resource potential on the flanks of the Sarqala structure deeper than the lowest known oil at 3,485 metres, nor the potential of an extension of this reservoir interval on the southwest flank of the structure. WesternZagros's combined mean estimate of gross unrisks prospective oil resources for these intervals increased to 198 MMbbl, or 250 MMBOE, as of September 7, 2011. Previously the mean estimate of gross unrisks prospective resources for the Jeribe reservoir of Sarqala-1 was 101 MMbbl, or 137 MMBOE. As at January 14, 2011 Western Zagros's mean estimate of gross unrisks prospective oil resources is 705 MMbbl in the Upper Fars Fault Trap Play, 120 MMbbl in the Bawanoor Saddle Play, 127 MMbbl in the Zardi prospect, 93 MMbbl in the Segrdan prospect, 25 MMbbl in the Chwar prospect, 17 MMbbl in the Alyan prospect, and 13 MMbbl in the Tilako prospect as of July 19, 2011. With the completion of these assessments the combined mean estimate of prospective resources on the Company's two contract areas in Kurdistan is 2.3 billion barrels of oil, or 3.7 billion barrels of oil equivalent. Further details on these resource assessments can be found in the material change reports of the Company dated September 14, 2011 and July 19, 2011.

Building on the significant discovery made at Sarqala-1, WesternZagros during the first half of 2012 will begin to design, plan and procure the necessary long lead materials and services for a 3D appraisal program, an appraisal well on Sarqala targeting the Jeribe reservoir ("Sarqala-2") and an exploration well on the Garmian Block to target the Oligocene reservoir ("Hasira-1") that would also appraise the Jeribe reservoir from the Sarqala structure. WesternZagros anticipates that the 3D seismic, Sarqala-2 and Hasira-1 would commence in the second half of 2012, dependent on the availability of the long lead materials and services, including drilling rigs.

Commenting on the third quarter results and subsequent events, WesternZagros's Chief Executive Officer Simon Hatfield said, "We have delivered strong operating performance through the achievements of the last few months, including our first sale of oil from the Sarqala extended well test, securing the necessary funding for our remaining commitments, and by spudding both the Mil Qasim-1 and Kurdamir-2 wells. Our current objectives are increasing oil production from Sarqala-1, completing the drilling and testing at the Mil Qasim-1 well and proving up our prospective oil resources with the Kurdamir-2 well."

## **Management's Discussion and Analysis**

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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 nine month periods ended September 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 September 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 November 18, 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 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 and appraisal 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 and production; 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. "Contingent resources" are those quantities of petroleum estimated, as of a given date, to be potentially recoverable from known accumulations using established technology or technology under development, but which are not currently considered to be commercially recoverable due to one or more contingencies. Contingent resources have an associated chance of development (economic, regulatory, market and facility, corporate commitment or political risks). The estimates referred to herein have not been risked for the chance of development. There is no certainty that the contingent resources will be developed and, if 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 contingent resources. All resource estimates presented are gross volumes for the indicated reservoirs, without any adjustment for the Company's 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, July 19, 2011, and September 14, 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, the significant positive and negative factors relevant to the estimates and, in respect of contingent resources, the specific contingencies which prevent the classification of the resources as reserves. In addition, combined mean estimates of resources which are presented in this MD&A are an arithmetic sum of the mean estimates for individual reservoirs and each such mean estimate is the average from the probabilistic assessment that was completed for the reservoir. Readers should refer to the foregoing material change reports for a detailed breakdown of the high (P10), low (P90) and best (P50) estimates for each of the individual reservoir assessments.

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. The Kurdamir and Garmian PSCs each govern separate contract areas (collectively referred to as the "PSC Lands"). The Garmian contract area (1,780 square kilometres) is operated by WesternZagros. The Kurdamir contract area (340 square kilometres) is operated by Talisman with a 40 percent working interest. WesternZagros holds a 40 percent working interest in both PSCs. The KRG holds a 20 percent working interest in both PSCs. The remaining 40 percent third party participant interest ("TPPI") of the Garmian PSC is held pending assignment by the KRG to a third party participant.

## **Basis of Presentation**

### **Reporting and Functional Currency**

The Company has prepared its September 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 and is in the exploration phase on its PSC Lands. WesternZagros's highlights and activities for the third quarter of 2011 and to November 18, 2011 include the following.

## **HSE&S**

- On October 27, 2011, WesternZagros's operations celebrated having worked one full year without a recordable injury incident. To this date, over 1.2 million hours of work have been performed safely. The dedication to safety demonstrated by all of the Company's employees and contractors has produced a work safety culture ranked as world class.
- WesternZagros continues to integrate health, safety, environmental and security matters into its business decisions and remains committed to playing a leadership role in this regard. Positive safety results indicate that the Company is on the right track.
- WesternZagros has achieved a total of 387 days without any Lost Time Incidents ("LTIs") to November 17, 2011.

## **Production**

- On October 18, 2011, first oil production from the Sarqala-1 extended well test was achieved. Production started at approximately 2,000 barrels of oil per day ("bopd") and is anticipated to increase towards 5,000 bopd by 2011 year end. The Sarqala-1 well initially tested 40 degree API crude oil at rates of over 9,000 bopd at a wellhead pressure of approximately 2,400 pounds per square inch. The well was not stimulated and is expected to continue to clean up and increase production capability during the extended well test.
- On October 27, 2011, WesternZagros sold its first oil produced from Sarqala-1 into the domestic market. To date, for the sales into the domestic market, WesternZagros has executed two sales contracts for total delivery of approximately 66,500 barrels of oil priced in the range of \$50 to \$60 per barrel, and under the terms of these sales contracts WesternZagros received payments totaling \$3.8 million in advance of delivery for these sales. Deliveries under these sales agreements to November 17, 2011 have totalled approximately 47,000 barrels of oil.

## **Operations**

- Mil Qasim-1, the Company's third exploration well, commenced drilling operations on August 29, 2011, on the Garmian Block in the Kurdistan Region of Iraq. After successfully setting the 13-5/8" casing at 1,615 metres in Mil Qasim-1, WesternZagros has drilled into the Upper Fars interval and has encountered over 88 metres of sands in the Upper Fars and had hydrocarbon shows, both oil and gas, while drilling. WesternZagros has completed logging these initial sands in the Upper Fars, set the 9-5/8" casing at 2,128 metres and is preparing to complete drilling to the estimated total depth of Mil Qasim-1 of 2,400 metres. Once total depth is reached, WesternZagros plans to conduct a testing program of the Upper Fars interval.
- The Kurdamir-2 exploration well commenced drilling operations on October 25, 2011, and is anticipated to be completed by June 2012. The well is being drilled on the flank of the Kurdamir structure approximately two kilometres from the Company's Kurdamir-1 discovery well and the well will target the Oligocene, Eocene and Cretaceous reservoirs. Talisman is the operator of the Kurdamir-2 well. To date Kurdamir-2 has been drilled to a depth of approximately 700 metres, where the first intermediate string of casing has been set. WesternZagros anticipates that the drilling and testing of the first reservoir, the Oligocene reservoir, will occur in the first quarter of 2012, with the deeper reservoirs, the Eocene and Cretaceous reservoirs, expected to be drilled and tested by the end of the second quarter of 2012.

## **Exploration**

- In the third quarter of 2011, Sproule International Limited ("Sproule") completed an independent audit of the Company's contingent and prospective resource estimates for the Jeribe/Upper Dhiban reservoir interval at Sarqala-1. As at September 7, 2011, the Company estimates gross unrisksed contingent oil resources for this interval of 9 MMbbl (low estimate), 21 MMbbl (best estimate), 44 MMbbl (high estimate) and 24 MMbbl (mean estimate). Contingent resources were assigned over a 66 metre gross pay zone from the top of the Sarqala reservoir down to 3,485 metres as determined by wireline logs and production testing. This contingent resource number does not include the significant prospective resource potential on the flanks of the Sarqala structure deeper than the lowest known oil at 3,485 metres, nor the potential of an extension of this reservoir interval on the southwest flank of the structure. The gross unrisksed prospective resources in the Sarqala structure deeper than the lowest know oil at 3,485 metres are 17 MMbbl (low estimate), 49 MMbbl (best

estimate), 125 MMbbl (high estimate) and 63 MMbbl (mean estimate). The gross unrisks prospective resources in the potential extension of the Jeribe reservoir on the southwest flank of structure are 14 MMbbl (low estimate), 87 MMbbl (best estimate), 304 MMbbl (high estimate) and 135 MMbbl (mean estimate). These estimated resources are in addition to the Company's prior audited estimates of prospective resources for the deeper reservoirs at Sarqala and the prior audited estimates of contingent resources and prospective resources for the Company's other prospects on the PSC Lands, including Mil Qasim and Kurdamir.

- In the third quarter of 2011, Sproule completed a further independent audit of the Company's resource assessments on 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). As at July 19, 2011, the combined mean estimate of gross unrisks prospective resources for these prospects was 1,099 million barrels of oil or 1,798 million barrels of oil equivalent when gas and condensate prospective resources are included.
- With the completion of these additional assessments, the combined mean estimate of prospective resources on the Company's two contract areas in Kurdistan is 2.3 billion barrels of oil, or 3.7 billion barrels of oil equivalent. Further details on these resource assessments can be found in the material change reports of the Company dated September 14, 2011 and July 19, 2011.
- 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 is expected to complete its Topkhana-1 well, which is located on the neighbouring Topkhana Block that is currently held by Talisman and the KRG, in the fourth quarter of 2011 and has tested the Oligocene reservoir in the prospect, though details of the results are not known. The Topkhana well results will impact the interpretation of the Kurdamir-Topkhana megastructure trap and the attractiveness of drilling offsetting prospects on the Garmian Block, notably Qulijan.

## Financial

- As at September 30, 2011, WesternZagros had \$20.4 million in working capital.
- On October 25, 2011, WesternZagros closed a strategic investment with the Abu Dhabi National Energy Company PJSC ("TAQA") whereby TAQA purchased from WesternZagros, through a private placement, 74 million common shares of the Company at a price of Cdn\$0.63 per share for gross proceeds of Cdn\$46,620,000. TAQA now holds approximately 19.9 percent of the Company's issued and outstanding common shares. The proceeds from the private placement will be used towards WesternZagros's 2011/2012 capital and operating program.
- For the nine months ended September 30, 2011, WesternZagros's share of capital expenditures, associated with its Garmian and Kurdamir PSC activities and other capitalized costs was \$58.5 million (net of disposals and prior to the impact of changes in non-cash investing capital). Year-to-date expenditures for 2011 included \$42.3 million of drilling-related costs; \$1.8 million for appraisal activities; \$1.5 million of geological and geosciences related work; \$4.0 million of supervision and field office costs; \$1.5 million of PSC-related expenditures; and \$7.4 million for corporate related activities. These expenditures reflect the requirement that WesternZagros currently fund 100 percent of the activities on the Garmian Block, with the Company to recover the third party participant's share of these costs when the KRG assigns the remaining interest in the Garmian Block.

## Insurance

- WesternZagros has concluded its insurance claim for a total of \$45 million relating to the Kurdamir-1 well. The final proceeds of \$4.4 million were received during the third quarter of 2011. The Company and its insurers have also renewed the Company's insurance policy for the drilling of the Kurdamir-2 well. The terms of the policy include an increase in the net aggregate limit from \$45 million to \$75 million.

## Corporate

- On October 27, 2011, David Cook, TAQA Executive Officer and Head of Oil and Gas, was appointed to the WesternZagros Board of Directors. Mr. Cook has in excess of 20 years of experience in the upstream oil and

gas sector through a variety of global technical, commercial and managerial positions based from the United States, United Kingdom, and Russia, as well as board directorships.

### **Political**

- Although the Iraq federal laws have yet to be enacted to address the future organization of Iraq's petroleum industry or the sharing of petroleum and other revenues within Iraq, in February 2011 an interim agreement was reached between the KRG and the federal government of Iraq with respect to the export and sale of crude oil from Kurdistan. The agreement is reported to provide 50 percent of the revenues from such sales to the KRG in order to reimburse the operators for costs associated with the producing fields. The KRG has confirmed receipt of two payments to date under this agreement, with the first payment received from the federal government equalling \$243 million for production from February and March and distributed to the operators in June. The second payment to the KRG pursuant to this interim agreement occurred in the third quarter of 2011, with the KRG confirming it has received \$207 million from the federal government for production from the second quarter of 2011. According to statements made by the KRG, a further approximate \$1 billion is owing for the oil exported to date from Kurdistan.
- The Parliament Oil and Energy Committee ("POEC") released a draft federal petroleum law in August 2011 that was based upon the 2007 draft federal petroleum law (the "2007 Draft Law") that was supported by the KRG and formed the basis for Kurdistan's Oil and Gas Law enacted in August 2007. The draft released by the POEC provided for greater involvement of the regions of Iraq in administering and issuing contracts related to oil and gas activities and was supported by both the KRG and the Kurdistan Alliance. The federal Council of Ministers, or Cabinet, subsequently released its draft of a federal petroleum law which centralized authority at the federal level and diminished the authority of the regions of Iraq. In October 2011, Iraqi Prime Minister Nuri Al-Maliki and Prime Minister Barham Salih, of the KRG, sidelined the two controversial oil and gas versions presented in August 2011 and agreed to, by the end of 2011, either amend the 2007 Draft Law, with agreement by all political factions, or adopt the 2007 Draft Law as is.

### **Corporate Social Responsibility**

- WesternZagros aspires to be an industry leader with respect to corporate social responsibility. The Company continues 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 in the third quarter of 2011 included:
  - An ongoing Environmental Impact Assessment data collection process for the Garmian Block;
  - Drilling and repairing water wells in several villages; digging sumps, pits and irrigation channels in several rural communities that did not have any other reliable sources of drinking water; and completion of water projects in Qulijan Sarhad village and Shakal village;
  - Commencement of a Community Health Awareness Program in Hasira and Mil Qasim villages, and completion of major refurbishments to the medical clinic in Aziz Qadr village;
  - Completion of approximately twenty earthworks projects providing infrastructure for new-build housing, road/access improvement and sanitation upgrades; significant upgrading of roads to both Mil Qasim and Hasira villages;
  - Refurbishment and upgrading of six primary schools in local villages; and ongoing purchasing and distribution of sports equipment throughout the Garmian region; and partnering with Heartland Alliance to facilitate 'mobile literary bus' educational visits to villages in Sarqala sub-district.

WesternZagros also continues to place a strong, yet safe, emphasis on the incremental development of local personnel capacity:

- Local Garmian village personnel are being trained and promoted to positions within drilling crews and within the extended well testing operations;
- Additional Garmian personnel trained and appointed as Health, Safety and Environment Technicians and Material & Logistics Supervisors; and
- All Garmian local rig labourers and rig crew completed 'Rig Pass' training and certification.

## **General and Administrative Expenses**

For the three and nine months ended September 30, 2011, WesternZagros expensed \$2.0 million and \$5.6 million in general and administrative expenses (“G&A”), respectively, as compared to \$0.9 million and \$4.2 million for the comparable periods in 2010. G&A costs were higher in 2011 due to increased personnel costs and a relatively stronger Canadian dollar in 2011, which impacts a large portion of the Company’s G&A expenditures.

For the nine months ended September 30, 2011, WesternZagros capitalized \$3.1 million of G&A (2010: \$1.4 million), including the capitalized portion of share-based payments. The amounts capitalized are directly related to the supervision of the Company’s exploration and evaluation activities. The increase in 2011 reflects the current requirement that WesternZagros fund 100 percent of the activities on the Garmian Block, prior to assignment of the TPPI by the KRG. For the three months ended September 31, 2011, WesternZagros capitalized \$1.0 million of G&A (2010: \$0.5 million), including the capitalized portion of share-based payments.

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

For the three and nine months ended September 30, 2011, WesternZagros had \$0.1 million and \$0.2 million, respectively, of depreciation related to certain administrative assets (2010: \$0.1 and \$0.4 million respectively). No depletion of exploration and evaluation expenditures will be recognized until such time that the technical feasibility and commercial viability has been demonstrated and development has been sanctioned, in which case the assets would then be tested for impairment and reclassified as development expenditures and then 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 September 30, 2011, WesternZagros recorded \$0.2 million in stock based compensation expense (2010: \$0.1 million) and \$0.2 million as part of capitalized G&A (2010: negligible), with a corresponding increase to contributed surplus. For the nine months ended September 30, 2011, WesternZagros recorded \$0.6 million in stock-based compensation expense (2010: \$0.6 million), and \$0.5 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 September 30, 2011, WesternZagros held approximately 90 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 September 30, 2011, WesternZagros recorded a foreign exchange loss of \$0.3 million relating to these conversions, compared to a \$0.1 million foreign exchange gain for the quarter ended September 30, 2010. For the nine months ended September 30, 2011, WesternZagros recorded a foreign exchange loss of \$0.3 million, compared to a \$0.1 million loss for the nine months ended September 30, 2010. As at September 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 or loss would have affected by approximately \$22,000.

## **Income Taxes**

For the quarter ended September 30, 2011, WesternZagros had a net income tax recovery of \$0.2 million (2010: \$0.1 million recovery), comprised of \$0.3 million of current income tax recovery (2010: \$0.1 million recovery) and a \$0.1 million deferred income tax expense (2010: negligible). For the nine months ended September 30, 2011, WesternZagros had a net income tax recovery of \$1.1 million (2010: \$0.9 million) comprised of current income tax recovery of \$1.2 million and partially offset by a \$0.1 million deferred tax expense (2010: \$1.0 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.

## **Other Income**

WesternZagros's other income is comprised entirely of interest earned on cash and cash equivalents and short-term investment balances. Interest of \$0.02 million was earned for the quarter ended September 30, 2011 compared to \$0.04 million for the quarter ended September 30, 2010. Interest of \$0.07 million was earned for the nine months ended September 30, 2011, compared to \$0.07 million for the nine months ended September 30, 2010.

## **Net Loss**

For the quarter ended September 30, 2011, WesternZagros recorded a net loss of \$2.0 million compared to a \$0.8 million loss for the quarter ended September 30, 2010. For the nine months ended September 30, 2011, WesternZagros recorded a net loss of \$4.9 million (2010: \$3.8 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 and foreign exchange losses for the first nine months of 2011 was offset by lower depreciation and increased tax recoveries as compared to the same period of 2010.

## **Capital Expenditures**

For the three months ended September 30, 2011, WesternZagros's share of capital expenditures associated with its activities and other capitalized costs was \$24.7 million (prior to the impact of changes in non-cash investing capital). Expenditures for the third quarter of 2011 included \$12.7 million of drilling-related costs; \$1.8 million for appraisal activities; \$0.6 million of geological and geosciences related work; \$1.7 million of supervision and field office costs; \$0.8 million of other PSC related expenditures; and \$7.1 million for corporate activities. These expenditures reflect the requirement that WesternZagros currently fund 100 percent of activities on the Garmian Block.

By comparison, WesternZagros's share of exploration and evaluation expenditures for the quarter ended September 30, 2010 associated with its activities was \$20.5 million, prior to insurance recoveries. Capital expenditures for the third quarter of 2010 included \$19.0 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; \$0.3 million of PSC-related costs; and \$0.2 million for corporate-related activities.

For the nine months ended September 30, 2011, WesternZagros's share of capital expenditures associated with its activities and other capitalized costs was \$58.5 million (net of disposals and prior to the impact of changes in non-cash investing capital). Expenditures included \$42.3 million of drilled-related costs; \$1.8 million for appraisal activities; \$1.5 million of geological and geosciences related work; \$4.0 million of supervision and field office costs; \$1.5 million of other PSC-related expenditures; and \$7.4 million for corporate activities. These expenditures reflect the requirement that WesternZagros currently fund 100 percent of activities on the Garmian Block.

By comparison, WesternZagros's share of exploration and evaluation expenditures for the nine months ended September 30, 2010 associated with its activities was \$49.6 million, prior to insurance recoveries. Expenditures included \$46.2 million of drilling-related costs; \$0.7 million of geological and geosciences work; \$1.9 million of supervision and field office costs; \$0.3 million of PSC-related expenditures; and \$0.5 million for corporate activities.

WesternZagros capitalized \$3.1 million of G&A expenses, including \$0.5 million of stock-based compensation, for the nine months ended September 30, 2011, compared to capitalizing \$1.4 million of G&A expenses, including a negligible amount of stock-based compensation, for the nine months ended September 30, 2010. For the three months ended September 31, 2011, the Company capitalized \$1.0 million of G&A expenses (2010: \$0.5 million), including \$0.2 million of stock-based compensation (2010: negligible amount).

Subsequent to September 30, 2011, the Company commenced production from an extended well test at Sarqala-1. Prior to sanctioning development, any production is considered to be test production and any associated proceeds received, net of applicable costs, will be credited to exploration and evaluation expenditures.

### 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 in each PSC 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 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."

WesternZagros's remaining PSC commitments are summarized in the following table:

	Kurdamir PSC	Garmian PSC
First exploration sub-period (expires)	June 30, 2012	December 31, 2011
Exploration obligation (remaining)	Kurdamir-2	Mil Qasim-1 exploration well
Second exploration sub-period	Additional two years	Additional two years
Exploration obligation	One appraisal well	One exploration well
Other extensions	Six month extension	One year extension
Work commitments	One appraisal well	One exploration well
Economic terms	Unchanged	Unchanged
PSC 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	Talisman	WesternZagros
Working interest	WesternZagros 40% Talisman 40% KRG 20% *	WesternZagros 40% Unassigned TPPI 40%** KRG 20% *
Contract area	340 km <sup>2</sup>	1,780 km <sup>2</sup>

\* WesternZagros funds the KRG costs, ultimately to be recovered by WesternZagros through the KRG's share of Cost Recovery Oil. For the Garmian Block, the current PSC requires that the third party participant will be required to pay for half of the KRG's carried share. This will be confirmed once the TPPI is assigned.

\*\* 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 September 30, 2011, the Company estimates expenditures of approximately \$52 million 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; the Company's annual funding requirements for certain technological, logistical, recruitment and training support under its PSCs; and other commitments related to the Kurdamir Block activities.

#### **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"). 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 September 30, 2011, the Company had approximately \$129 million related to the Garmian PSC and \$98 million relating to the Kurdamir 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 applicable 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. Subsequent to September 30, 2011, the Company signed two separate oil sales contracts, with the approval from the Ministry, to sell initial test production from Sarqala-1 to local buyers based on an auction process within local markets at prices between \$50 and \$60 per barrel. With continued approval from the Ministry of Natural Resources of the KRG, any future sales contracts for ongoing test production from Sarqala-1 could continue to be sold via the local auction market process or alternatively sold for export depending on local demand.

Pursuant to the terms of the Kurdamir and Garmian PSCs, the price for natural gas is based on local commercial value and Iraq tariffs. However, limited markets exist for natural gas within Iraq and there is limited infrastructure for export. The KRG has as one of its priorities the expansion of its electricity generation and is pursuing a number of projects that may expand these markets and the demand for natural gas.

### Other Commitments

The Company has entered into 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 Garmian PSC and other contractual obligations at September 30, 2011:

	For the Years Ending December 31,					
	2011	2012	2013	2014	2015+	Total
Exploration	\$1,437	-	-	-	-	\$1,437
Office	\$162	\$602	\$559	\$456	-	\$1,779
	\$1,599	\$602	\$559	\$456	-	\$3,216

### Legal Proceedings

From time to time, the Company may become involved in legal or administrative proceedings in the normal conduct of business. The Company is currently in disputes with two contractors, one is related to compensation owing to a contractor under a terminated agreement and the other is over a potential breach of contract by a contractor related to services provided to the Company. Although there has been no formal claim of monetary damages to date in either of the matters, the Company does not currently expect that the matters, individually or in aggregate, would have a material impact on the Company's financial position. The Company continues to pursue resolution of these disputes, and will enforce its contractual rights through arbitration if necessary. Notice of arbitration has been received by the Company with respect to one of these disputes. Given the early stage of the disputes there is no certainty as to the ultimate outcome of any such proceedings. Amounts involved in such matters are not reasonably estimable due to uncertainty as to the final outcome.

### 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 September 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 relating to the Kurdamir-1 well, with the final proceeds due of \$4.4 million received during the third quarter of 2011. The Company and its insurers have also renewed the Company's insurance policy for the drilling of the Kurdamir-2 well. The terms of the policy include an increase in the net aggregate limit from \$45 million to \$75 million.

## Outlook

WesternZagros's plans for the remainder of 2011 and for fiscal 2012 are to focus its exploration and appraisal programs on the highly prospective formations discovered through the Sarqala-1 and Kurdamir-1 wells. These exploration and appraisal programs will further delineate the approximately one billion barrels of oil equivalent of mean gross unrisked prospective resources that these formations are estimated to contain (prospective resources estimated as of December 14, 2010, January 14, 2011, January 31, 2011 and September 7, 2011, as audited by Sproule International Limited – see "Forward Looking Information").

Activities on the Garmian Block for the remainder of 2011 and for fiscal 2012 are planned to include the Sarqala extended well test, the drilling and testing of Mil Qasim-1, completing a 3D seismic appraisal program for the Sarqala discovery and completing the design, drilling plan and necessary procurement for both an exploration well and a Sarqala appraisal well. Activities on the Kurdamir Block for the remainder of 2011 and for fiscal 2012 are planned to include the drilling and testing of Kurdamir-2 and planning for further appraisal activities, including a potential 3D seismic program and future appraisal wells.

On October 27, 2011, WesternZagros began producing oil from the extended well test at Sarqala-1 and is estimating achieving production rates of approximately 2,000 bopd for the remainder of 2011. Production is currently being restricted to 2,000 bopd, however the Company expects to increase production to approximately 5,000 barrels per day by the end of 2012, through the addition of more tank capacity, the construction of a new weighbridge at site and the construction of a new road from the facilities to the highway that will by-pass the neighbouring village.

Further engineering work has also commenced in the fourth quarter of 2011 and is expected to be completed in the first half of 2012 with respect to sourcing permanent facilities and optimizing the location of these facilities for increasing future production beyond 5,000 barrels per day from the Sarqala-1 well and future wells on the Sarqala structure. This work will include the necessary facilities to utilize the associated natural gas from this crude oil production.

On August 29, 2011, WesternZagros spudded the Garmian Block exploration commitment well at Mil Qasim-1, located three kilometres from Sarqala-1. After successfully setting the 13-5/8 inch casing at 1,615 metres in Mil Qasim-1, WesternZagros has drilled into the Upper Fars interval and has encountered over 88 metres of sands in the Upper Fars and had hydrocarbon shows, both oil and gas, while drilling. WesternZagros has completed logging these initial sands in the Upper Fars, set the 9-5/8 inch casing at 2,128 metres and is preparing to complete drilling to the estimated total depth of Mil Qasim-1 of 2,400 metres. Once total depth is reached, WesternZagros plans to conduct a testing program of the Upper Fars interval. If the testing at Mil Qasim-1 confirms a discovery, WesternZagros will look to complete an extended well test at Mil Qasim-1 and examine ways to appraise and develop Mil Qasim in combination with the Sarqala discovery.

During the first half of 2012, WesternZagros expects to design, plan and procure the necessary long lead materials and services for a 3D appraisal program, an appraisal well on Sarqala targeting the Jeribe reservoir ("Sarqala-2") and an exploration well on the Garmian Block to target the Oligocene reservoir ("Hasira-1") that would also appraise the Jeribe reservoir from the Sarqala structure. WesternZagros anticipates that the 3D seismic, Sarqala-2 and Hasira-1 would commence in the second half of 2012, dependent on the availability of the long lead materials and services, including drilling rigs.

The Kurdamir-2 exploration well was spudded on October 25, 2011 and is being operated by Talisman. The well is being drilled on the flank of the Kurdamir structure approximately two kilometres from the Kurdamir-1 discovery well and the well will target the Oligocene, Eocene and Cretaceous reservoirs. WesternZagros anticipates that the drilling and testing of the first reservoir, the Oligocene reservoir, will occur in the first quarter of 2012, with the deeper reservoirs, the Eocene and Cretaceous reservoirs, expected to be drilled and tested by the end of the second quarter of 2012. WesternZagros continues to evaluate with its co-venturer Talisman options for early production at Kurdamir of crude oil, condensate and natural gas.

WesternZagros estimates its capital and operating expenditures for the fourth quarter of 2011, including the requirement for the Company to fund 100 percent of Mil Qasim-1 until the TPPI is assigned and to fund its share of the costs of the Kurdamir-2 well, to be approximately \$37 million. This includes approximately \$13 million for drilling and related costs for Kurdamir-2, \$19 million for drilling and related costs for Mil Qasim-1, \$3.5 million for in-country support costs related to both Kurdamir-2 and Mil Qasim and the remainder of the budget comprised of funds for corporate general and administrative costs.

For the first half of fiscal 2012, WesternZagros estimates its capital and operating expenditures, including the requirement for the Company to fund 100 percent of Garmian activities in 2012 until the assignment of the TPPI by the KRG and to fund its share of the costs of the Kurdamir-2 well, to be approximately \$47-57 million. This includes approximately \$30-35 million for drilling and testing Kurdamir-2; \$10-15 million for designing, planning, procurement of the necessary long lead materials for the Sarqala-2 and Hasira-1 wells and the appraisal 3D seismic program; \$4 million for in-country support costs and other PSC expenditures for both the Kurdamir and Garmian Blocks; and approximately \$3 million for corporate and general and administrative costs. This excludes any of the proceeds from the sale of crude oil from the extended well test at Sarqala-1 and the reimbursement of the costs on the Garmian Block that WesternZagros has funded and will be reimbursed upon the assignment of the TPPI by the KRG.

### **Liquidity and Capital Resources**

WesternZagros is currently exploring for and appraising discoveries of crude oil and natural gas in the Kurdistan Region of Iraq. Subsequent to September 30, 2011, the Company commenced an extended well test and the sale of crude oil test production from the Sarqala-1 exploration well. Prior to sanctioning development, any production is considered to be test production and any associated proceeds received, net of applicable costs, will be credited to exploration and evaluation expenditures. WesternZagros's other income 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.

As at September 30, 2011, WesternZagros had \$20.4 million in working capital and no outstanding bank debt or other interest bearing indebtedness. Subsequent to September 30, 2011, the Company also raised an additional Cdn\$46.6 million through a private placement of 74 million shares. WesternZagros has granted certain rights to TAQA to participate for its pro-rata share in future equity issuances and the shares issued are subject to a hold period until June 30, 2012.

During the fourth quarter of 2011, WesternZagros began oil production from the Sarqala-1 extended well test and sales of this test production into the domestic market in Kurdistan. Under the terms of the contracts entered into for the sale of this production, the purchasers have prepaid WesternZagros for the production, with payments received to date for both October and November production totalling approximately \$3.8 million. WesternZagros will use these cash proceeds, along with sales proceeds from further production from the extended well test to fund future exploration and appraisal activities. WesternZagros may be required to access further funding over time dependent on the level and timing of exploration and appraisal activities pursued by the Company and the funding requirements under the relevant PSCs.

WesternZagros will monitor the timing and likelihood of the TPPI 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. WesternZagros, in considering the proper timing to potentially access further capital, will also assess the following factors:

- Continuation of the Sarqala-1 extended well test and sale of the related production;
- The expected timing for exploration results from Mil Qasim-1 and Kurdamir-2;
- The expected timing for appraisal activities at Sarqala and future exploration activities, including the 3D seismic program, the drilling of Sarqala-2 and the drilling of Hasira-1;

- The ability to export oil and natural gas from the Kurdistan Region of Iraq in accordance with the economic terms under the PSCs 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 commencement of production from the Sarqala-1 extended well test and the receipt of proceeds from the sale of its production, the completion of the Company's recent private placement and the general industry interest in the Kurdistan Region, management has a reasonable expectation that any future capital requirements will be able to be met through either further equity issuances or sales proceeds generated from extended well tests.

### Outstanding Share Data

As at November 18, 2011, the total number of shares outstanding was 371,209,472, including the 74 million shares issued to TAQA subsequent to September 30, 2011.

The total number of options outstanding as at November 18, 2011 was 18,778,700, including 48,000 options granted to, and 126,667 stock options forfeited by, employees and contractors subsequent to September 30, 2011.

### 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			
	Sept 30 2011	Jun 30 2011	Mar 31 2011	Dec 31 2010
Total Revenue	16	34	17	13
Net Loss	2,013	1,416	1,480	2,003
Net Loss Per Share (US\$ Per Share) (Basic and Fully Diluted)	0.007	0.005	0.006	0.010
Capital Expenditures, net of disposals	24,649	18,420	15,494	17,283
Total Assets	275,078	272,650	271,720	240,290
Total Non-Current Liabilities	1,417	864	816	649
Dividend (US\$ per Share)	Nil	Nil	Nil	Nil

	Three Month Periods Ended			
	Sept 30 2010	Jun 30 2010	Mar 31 2010	Dec 31 2009
Total Revenue	38	17	19	32
Net Loss	819	1,646	1,333	1,035
Net Loss Per Share (US\$ Per Share) (Basic and Fully Diluted)	0.004	0.008	0.006	0.005
Capital Expenditures	20,455	15,962	13,153	11,250
Total Assets	233,770	235,295	235,514	241,077
Total Non-Current Liabilities	665	624	573	175
Dividend (US\$ per Share)	Nil	Nil	Nil	Nil

## RISK FACTORS

The risks factors that could influence actual results are described in the Company's 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 also 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, the timing and likelihood of the Garmian TPPI being assigned and the Company's potential 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 environmental damage, and 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; environmental risks; delays or changes in plans with respect to exploration or development projects or capital expenditures; the ability to attract key personnel and; 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 detailed list of risk factors please refer to the 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). In addition to such risk factors, readers should consider the following additional risks related to the Company's recent start of extended well test operations:

Operations related to extended well tests are subject to all of the risks and hazards typically associated with production operations, including hazards such as fire, explosion, releases and spills, each of which could result in substantial damage to production facilities or the environment or result in personal injury or death.

In addition, the Company will initially be relying on trucking to transport oil to export terminals or domestic markets. This method of transportation may be subject to additional risks as compared to transport by pipeline, including the risk of vehicle accident during transport. Any loss of capacity or delay in transportation may negatively impact testing operations and the sale of oil production.

There is no guarantee that the Company will continue to be able to effectively market oil produced from extended well tests. If the Company is required to deliver its crude oil to the export market there may be a delay in the collection of revenue due to the fact that proceeds from the sale of this crude oil will be collected by the federal government for distribution to the KRG, and then ultimately the Company. The Company, if selling into the

domestic market, may be exposed to third-party credit risk through its contractual arrangements with buyers of its production from extended well tests if buyers are not required to pre-pay for production. In the event buyers fail to meet their obligations to pay, or there are significant delays in payments from any sales to the export market, such events could negatively affect the Company.

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

The Company has prepared its September 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 September 30, 2011 Condensed Consolidated Interim Financial Statements. Prior period reconciliations between IFRS and previous GAAP are included within Note 24 to the September 30, 2011 Condensed Consolidated Interim Financial Statements. In summary, Note 24 includes the following reconciliations:

- Balance Sheets as at January 1, 2010, September 30, 2010 and December 31, 2010;
- Statements of Comprehensive Loss for the three and nine month ended September 30, 2010 as well as for the year ended December 31, 2010; and
- Statements of Cash Flows for the three and nine months ended September 30, 2010 as well as for the year ended 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 originally had only one PSC in that region covering all of the PSC Lands, 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 September 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 judgements 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 27, “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	September 30, 2011	December 31, 2010 (Note 24)	January 1, 2010 (Note 24)
<b>Assets</b>				
<b>Current assets</b>				
Cash and cash equivalents	7	\$35,162	\$31,482	\$76,708
Trade and other receivables	8	284	8,648	6,880
Insurance recoveries receivable		-	17,597	-
Deposits held in trust	11	-	420	-
Prepaid expenses		237	39	183
Income tax recoverable	12	1,847	887	1,738
<b>Total current assets</b>		<b>37,530</b>	59,073	85,509
<b>Non-current assets</b>				
Deposits held in trust	11	-	-	420
Property, plant and equipment	10	110	261	814
Exploration and evaluation expenditures	9	237,347	180,770	154,097
Deferred tax assets	12	91	186	371
<b>Total non-current assets</b>		<b>237,548</b>	181,217	155,702
<b>Total assets</b>		<b>\$275,078</b>	\$240,290	\$241,211
<b>Liabilities</b>				
<b>Current liabilities</b>				
Trade and other payables	13	\$17,176	\$21,525	\$18,297
<b>Total current liabilities</b>		<b>17,176</b>	21,525	18,297
<b>Non-current liabilities</b>				
Provision for decommissioning obligations	14	1,250	509	432
Deferred tax liabilities	12	167	140	134
<b>Total non-current liabilities</b>		<b>1,417</b>	649	566
<b>Total liabilities</b>		<b>18,593</b>	22,174	18,863

**Equity**

Share capital	15	<b>295,784</b>	253,583	253,583
Contributed surplus	16	<b>12,300</b>	11,223	9,654
Deficit		<b>(51,599)</b>	(46,690)	(40,889)
<b>Total equity</b>		<b>256,485</b>	218,116	222,348
<b>Total equity and liabilities</b>		<b>\$275,078</b>	\$240,290	\$241,211

Commitments and contingencies (Note 22)

Subsequent events (Note 23)

*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 Audit Committee of the Board of Directors on November 18, 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 September 30,		Nine months ended September 30,	
		2011	2010	2011	2010
<b>Other Income</b>					
Other income		\$16	\$38	\$67	\$74
<b>Expenses</b>					
General and administrative expenses	17, 18	1,958	929	5,601	4,175
Depreciation		50	132	151	443
Accretion	14	5	4	17	12
Foreign exchange (gain)loss		259	(140)	330	105
Total expenses		2,272	925	6,099	4,735
<b>Loss before taxation</b>		<b>2,256</b>	887	<b>6,032</b>	4,661
<b>Taxation</b>					
Current	12	(327)	(111)	(1,244)	(1,014)
Deferred	12	84	43	121	151
Total taxation (recovery)		(243)	(68)	(1,123)	(863)
<b>Total loss and comprehensive loss for the period attributable to the shareholders</b>		<b>\$2,013</b>	\$819	<b>\$ 4,909</b>	\$3,798
<b>Net loss per share – basic and diluted</b>	19	<b>\$0.007</b>	\$0.004	<b>\$0.018</b>	\$0.018

*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>	24	207,464,320	\$253,583	\$ 9,654	\$(40,889)	\$ 222,348
Share based payments		-	-	544	-	544
Loss for the period		-	-	-	(3,798)	(3,798)
<b>Balance September 30, 2010</b>	24	207,464,320	253,583	10,198	(44,687)	219,094
Share based payments		-	-	1,025	-	1,025
Loss for the period		-	-	-	(2,003)	(2,003)
<b>Balance December 31, 2010</b>	24	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	79,800	64	(21)	-	43
Share issuance costs		-	(2,090)	-	-	(2,090)
Share based payments	16, 17	-	-	1,098	-	1,098
Loss for the period		-	-	-	(4,909)	(4,909)
<b>Balance September 30, 2011</b>		297,209,472	\$295,784	\$12,300	(51,599)	\$256,485

*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 September 30,		Nine months ended September 30,	
		2011	2010	2011	2010
<b>Cash flow from operating activities</b>					
Net loss before taxation		\$(2,256)	\$(887)	\$(6,032)	\$(4,661)
Adjustments for					
Depreciation		50	132	151	443
Accretion	14	5	4	17	12
Share based payments	16, 17	197	106	635	593
Income taxes recovered		283	-	283	598
Change in non-cash operating working capital	21	1,516	402	(182)	143
Net cash from (used in) operating activities		(205)	(243)	(5,128)	(2,872)
<b>Cash flow from investing activities</b>					
Expenditures on exploration and evaluation	21	(19,731)	(23,710)	(54,481)	(59,400)
Disposals of assets		2	-	463	-
Insurance recoveries		4,446	10,284	20,646	15,664
Net cash from (used in) investing activities		(15,283)	(13,426)	(33,372)	(43,736)
<b>Cash flow from financing activities</b>					
Issuance of common shares, net of costs		(56)	-	42,137	-
Proceeds from options exercised		38	-	43	-
Net cash from (used in) financing activities		(18)	-	42,180	-
<b>Change in cash and cash equivalents</b>					
		(15,506)	(13,669)	3,680	(46,608)
Cash and cash equivalents, beginning of period		50,668	43,769	31,482	76,708
<b>Cash and cash equivalents, end of period</b>		<b>\$35,162</b>	<b>\$30,100</b>	<b>\$35,162</b>	<b>\$30,100</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 nine months ended September 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 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 by the 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 “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 nine months ended September 30, 2011 were authorized for issuance in accordance with a resolution of the Audit Committee of the Board of Directors on November 18, 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 September 30, 2011. During the three months ended September 30, 2011, the Company had expenditures of \$0.2 million for operating activities and \$19.7 million for investing activities related to exploration and evaluation assets,

including changes in non-cash working capital. During the nine months ended September 30, 2011, the Company had expenditures of \$5.1 million for operating activities and \$54.5 million for investing activities related to exploration and evaluation assets, including changes in non-cash working capital. The Company may 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, including its recent Cdn \$46.6 million equity financing described in Note 23 "Subsequent events", 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 "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 next twelve months of operations and is dependent on the level and timing of exploration and appraisal activities pursued by the Company and the funding requirement of the Company under the relevant PSCs.

### **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 as at and for the three and nine months ended September 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 24 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 (Garmian) 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 “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 (“E&E 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 E&E expenditures. E&E expenditures 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 E&E expenditures until such time that the technical feasibility and commercial viability of the crude oil and natural gas hydrocarbons has been demonstrated and development has been sanctioned. At that point the E&E expenditures are assessed for impairment and then transferred to development expenditures. Prior to sanctioning development, any production is considered to be test production and any associated proceeds received, net of applicable costs are credited to E&E 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 E&E 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, E&E 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 E&E expenditure’s carrying value exceeds its recoverable amount. The recoverable amount is the higher of the E&E 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 E&E 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 E&E 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. Other income**

The Company recognizes other income on an accrual basis and 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 27, "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, and reviewed regularly by the Board of Directors. The risk management policies employed by the Company are discussed below:

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 the Garmian PSC, 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, and Talisman's 40 percent interest in the Kurdamir PSC for gross costs incurred by WesternZagros while operator under the Kurdamir 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 "Commitments and contingencies" for a description of the PSCs).

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:

<u>As at</u>	<u>September 30, 2011</u>	<u>December 31, 2010</u>
Cash and cash equivalents	\$35,162	\$ 31,482
Trade and other receivables	284	8,648
Insurance recoveries receivable	-	17,597
Deposits held in trust	-	420
<u>Total</u>	<u>\$35,446</u>	<u>\$ 58,147</u>

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. The Company is engaged in acquiring properties and exploring for crude oil and natural gas and is in the exploration phase, and subsequent to September 30, 2011 has commenced an extended well test and the sale of crude oil test production from the Sarqala-1 exploration well. The Company funds its share of all commitments from existing cash balances, the proceeds from any sales of test production resulting from the extended well test and by accessing additional sources of funding from debt or equity markets.

The Company's capital structure consists of shareholder's equity and working capital. 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 \$17.2 million are all current liabilities due in less than 1 year. Certain commitments of approximately \$3.2 million identified in Note 22 "Commitments and contingencies" are also due within 1 year of the reporting date. 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 "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 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 "Commitments and contingencies" for a description of the PSCs), as well as an assessment of any potential proceeds 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.

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.

### 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 September 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 \$0.02 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 nine months ended September 30, 2011, Brent daily spot crude prices ranged in value from \$93 to \$126 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 E&E 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 "Commitments and contingencies" for a description of the PSCs.

## 7. Cash and cash equivalents

	September 30, 2011	December 31, 2010	January 1, 2010
Bank balances	\$3,064	\$3,613	\$6,609
Term deposits	32,098	27,869	70,099
Cash and cash equivalents	\$35,162	\$31,482	\$ 76,708

## 8. Trade and other receivables

Current	September 30, 2011	December 31, 2010	January 1, 2010
Joint venture receivables	\$ -	\$7,675	\$6,636
Other receivables	284	973	53
Loan receivable from related party	-	-	191
Total trade and other receivables	\$284	\$8,648	\$6,880

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.

All classes within trade and other receivables do not contain any impaired assets.

## 9. Exploration and evaluation expenditures

As at	September 30, 2011	December 31, 2010	January 1, 2010
Costs	\$237,347	\$180,770	\$ 154,097
Accumulated impairment	-	-	-
Net book value	\$237,347	\$180,770	\$ 154,097

	Nine months ended September 30, 2011	Twelve months ended December 31, 2010
Opening net book value	\$180,770	\$ 154,097
Additions, net of insurance recoveries	57,040	26,673
Disposals	(463)	-
Impairment	-	-
Closing net book value	\$237,347	\$ 180,770

All E&E 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 E&E expenditures as at September 30, 2011 is \$0.9 million related to provisions for decommissioning obligations (December 31, 2010: \$0.2 million). For the nine months ended September 30, 2011, the Company has capitalized \$3.1 million of general and administrative costs (September 30, 2010: \$1.4 million), including \$0.5 million of

share-based compensation costs (September 30, 2010: negligible amount) directly related to exploration activities. All E&E expenditures are excluded from depreciation.

As at September 30, 2011, the Company had approximately \$227 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 "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 from 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>September 30, 2011</b>	<b>December 31, 2010</b>	<b>January 1, 2010</b>
Costs	\$1,830	\$1,830	\$ 1,830
Accumulated impairment	-	-	-
Accumulated depreciation	(1,720)	(1,569)	(1,016)
Net book value	\$110	\$261	\$ 814

<b>Period ended</b>	<b>Nine months ended September 30, 2011</b>	<b>Twelve months ended December 31, 2010</b>
Opening net book value	\$261	\$ 814
Additions	-	-
Impairment	-	-
Depreciation	(151)	(553)
Closing net book value	\$110	\$ 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 nine months ended September 30</b>	<b>2011</b>	<b>2010</b>
Current income tax recovery	\$(1,244)	\$(1,014)
Future income tax expense (recovery)	121	151
<b>Income tax expense (recovery)</b>	<b>\$ (1,123)</b>	<b>\$ (863)</b>

The deferred income tax asset is comprised of:

<b>Deferred income tax asset as at</b>	<b>September 30, 2011</b>	<b>December 31, 2010</b>	<b>January 1, 2010</b>
Share issue costs	\$82	\$204	\$408
Temporary differences on property, plant and equipment	9	(18)	(37)
<b>Total deferred income tax asset</b>	<b>\$91</b>	<b>\$186</b>	<b>\$371</b>

The deferred income tax liability is comprised of:

<b>Deferred income tax liability as at</b>	<b>September 30, 2011</b>	<b>December 31, 2010</b>	<b>January 1, 2010</b>
Temporary differences on property, plant and equipment	\$167	\$140	\$161
Non-capital loss carryforwards	-	-	(27)
<b>Total deferred income tax liability</b>	<b>\$167</b>	<b>\$140</b>	<b>\$134</b>

## 13. Trade and other payables

<b>Current</b>	<b>September 30, 2011</b>	<b>December 31, 2010</b>	<b>January 1, 2010</b>
Trade payables	\$ 370	\$ 4,052	\$ 6,705
Accruals	16,806	17,473	11,592
<b>Total trade and other payables</b>	<b>\$17,176</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 E&E and other 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 assumed to be incurred in the years 2035 and 2036 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 \$2.4 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 obligations incurred in 2011 relate to the Company's 100 percent working interest funding for the Sarqala-1 re-entry operation as well as the drilling operations at Mil Qasim-1 (also refer to Note 22 "Commitments and contingencies" for a description of the PSCs).

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

	<b>Nine months ended September 30, 2011</b>	<b>Twelve months ended December 31, 2010</b>
Balance, beginning of period	\$ 509	\$ 432
Additional obligations incurred	662	-
Changes in estimates or timing of cash flows	62	61
Accretion	17	16
Balance, end of period	\$ 1,250	\$ 509

## **15. Share capital**

As at September 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
Outstanding, end of year	20,354,900	\$1.00
Exercisable at December 31, 2010	12,143,965	\$1.30

<b>For the three months ended September 30, 2011</b>	Number of Options	Weighted average exercise price (\$Cdn)
Outstanding, beginning of period	19,585,033	\$0.97
Granted	535,000	0.55
Exercised	(70,600)	0.51
Forfeited and expired	(1,192,066)	0.85
Outstanding, end of period	18,857,367	\$0.97

<b>For the nine months ended September 30, 2011</b>	Number of Options	Weighted average exercise price (\$Cdn)
Outstanding, beginning of period	20,354,900	\$1.00
Granted	582,000	0.56
Exercised	(79,800)	0.51
Forfeited and expired	(1,999,733)	1.17
<b>Outstanding, end of period</b>	<b>18,857,367</b>	<b>\$0.97</b>
<b>Exercisable at September 30, 2011</b>	<b>10,727,898</b>	<b>\$1.31</b>

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:

	Nine months ended September 30, 2011	Twelve months ended December 31, 2010
Weighted average fair value of stock options granted	\$0.37	\$0.29
Average Risk Free Interest Rate	1.16%	1.62%
Expected Life	3 years	2 - 3 years
Average Expected Volatility	108%	120%
Dividend Per Share	Nil	Nil

During the nine months ended September 30, 2011, the Company recognized \$0.6 million (2010: \$0.6 million) of stock based compensation as general and administrative expense and capitalized \$0.5 million (2010: negligible amount).

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

<b>For the nine months ended September 30</b>	<b>2011</b>	<b>2010</b>
Staff expenses	\$4,379	\$3,492
Share-based payments	635	593
Travel expenses	725	337
Professional fees	924	924
Office costs	823	820
Regulatory and corporate project costs	414	538
Other administrative expenses	370	314
Less capitalized general and administrative costs	(2,669)	(2,843)
<b>Total administrative expenses</b>	<b>\$5,601</b>	<b>\$4,175</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 eleven 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 nine months ended September 30</b>	<b>2011</b>	<b>2010</b>
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Salaries and employee benefits	\$1,335	\$945
Share-based compensation expense	636	505
<b>Total</b>	<b>\$1,971</b>	<b>\$1,450</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 18,857,367 (September 30, 2010 – 11,482,334) 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 September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Loss for the period	\$2,013	\$819	\$4,909	\$3,798
Weighted-average common shares (000's)	297,191	207,464	274,816	207,464
<b>Loss per share (basic and diluted)</b>	<b>\$0.007</b>	<b>\$0.004</b>	<b>\$0.018</b>	<b>\$0.018</b>

## **20. Shareholder rights plan**

On October 18, 2007, the Company 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 Company, 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:

	<b>For the three months ended September 30,</b>		<b>For the nine months ended September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Expenditures on exploration and evaluation assets	<b>\$(24,651)</b>	\$(20,455)	<b>\$(59,026)</b>	\$(49,570)
Change in non-cash investing working capital	<b>4,920</b>	(3,255)	<b>4,545</b>	(9,830)
	<b>\$(19,731)</b>	\$(23,710)	<b>\$(54,481)</b>	\$(59,400)

Changes in non-cash working capital is comprised of:

	<b>For the three months ended September 30,</b>		<b>For the nine months ended September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>

**Related to operating activities**

Trade and other receivables	\$1,294	\$232	\$16	\$185
Prepaid expenses	222	170	(198)	(42)
Trade and other payables	-	-	-	-
	<b>\$1,516</b>	\$402	<b>\$(182)</b>	\$143

**Related to investing activities**

Trade and other receivables	\$1,377	\$(908)	\$8,768	\$(4,045)
Trade and other payables	3,543	(2,347)	(4,223)	(5,785)
	<b>\$4,920</b>	\$(3,255)	<b>\$4,545</b>	\$(9,830)

**22. Commitments and contingencies****A. PSC commitments**

During the third quarter of 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 divided the contract area of the Original PSC into two contract areas named Garmian and Kurdamir (see chart below), each of which is now operated under a distinct PSC.

WesternZagros continues 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	Additional Capacity Building Support Payment payable equal to 3% of WesternZagros	Additional Capacity Building Support Payment payable equal to 3% of WesternZagros Profit Oil.

	\$ 1.1 Million Annual Payments	Profit Oil. Continuation of previous annual payments.	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. For the Garmian Block, the current PSC requires that the third party participant will be required to pay for half of the KRG's carried share. This will be confirmed once the TPPI is assigned.

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

As at September 30, 2011, the Company estimates expenditures of approximately \$52 million 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; the Company's annual funding requirements for certain technological, logistical, recruitment and training support under its PSCs; and other commitments related to Kurdamir Block activities.

## B. Other commitments

The Company has entered into 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 Garmian PSC and other contractual obligations at September 30, 2011:

	For the Years Ending December 31,					
	2011	2012	2013	2014	2015+	Total
Exploration	\$1,437	-	-	-	-	\$1,437
Office	\$162	\$602	\$559	\$456	-	\$1,779
	\$1,599	\$602	\$559	\$456	-	\$3,216

## C. Contingencies

### i. Litigation

From time to time, the Company may become involved in legal or administrative proceedings in the normal conduct of business. The Company is currently in disputes with two contractors, one is related to compensation owing to a contractor under a terminated agreement and the other is over a potential breach of contract by a contractor related to services provided to the Company.

Although there has been no formal claim of monetary damages to date in either of the matters, the Company does not currently expect that the matters, individually or in aggregate, would have a material impact on the Company's financial position. The Company continues to pursue resolution of these disputes, and will enforce its contractual rights through arbitration if necessary. Notice of arbitration has been received by the Company with respect to one of these disputes. Given the early stage of the disputes, there is no certainty as to the ultimate outcome of such proceedings.

Amounts involved in such matters are not reasonably estimable due to uncertainty as to the final outcome.

**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. Subsequent events**

Subsequent to September 30, 2011, WesternZagros completed a private placement of common shares in which 74 million common shares were issued to the Abu Dhabi National Energy Company PJSC at a price of Cdn \$0.63 per share. Total gross proceeds received were Cdn \$46.6 million. Also subsequent to September 30, 2011, WesternZagros sold its first oil produced from the Sarqala-1 extended well test. WesternZagros has executed two sales contracts for total delivery of approximately 66,500 barrels of oil and has received payments totaling \$3.8 million in advance of delivery for his test production. Deliveries under these sales agreements to November 17, 2011, have totaled approximately 47,000 barrels of oil.

### **24. 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 nine months ended September 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 E&E 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 E&E 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 – September 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		\$30,100	\$ -	\$30,100
Trade and other receivables		10,739	-	10,739
Insurance recoveries receivable	a	21,270	(20,108)	1,162
Prepaid expenses		225	-	225
Income tax recoverable		2,155	-	2,155
Future income tax assets	b	127	(127)	-
<b>Total current assets</b>		<b>64,616</b>	<b>(20,235)</b>	<b>44,381</b>
<b>Non-current assets</b>				
Property, plant and equipment	c	169,519	(169,148)	371
Exploration and evaluation expenditures	c	-	188,373	188,373
Deposits held in trust		420	-	420
Deferred income tax assets	b	-	225	225
<b>Total non-current assets</b>		<b>169,939</b>	<b>19,450</b>	<b>189,389</b>
<b>Total assets</b>		<b>\$234,555</b>	<b>\$(785)</b>	<b>\$233,770</b>
<b>Liabilities</b>				
<b>Current liabilities</b>				
Accounts payable and accrued liabilities		\$14,011	\$ -	\$14,011
<b>Total current liabilities</b>		<b>14,011</b>	<b>-</b>	<b>14,011</b>
<b>Non-current liabilities</b>				
Provision for decommissioning obligations	d	186	339	525
Deferred tax liabilities	b	42	98	140
<b>Total non-current liabilities</b>		<b>228</b>	<b>437</b>	<b>665</b>
<b>Total liabilities</b>		<b>14,239</b>	<b>437</b>	<b>14,676</b>
<b>Equity</b>				
Share capital		253,583	-	253,583
Contributed surplus	e	10,284	(86)	10,198
Deficit	f	(43,551)	(1,136)	(44,687)
<b>Total equity</b>		<b>220,316</b>	<b>(1,222)</b>	<b>219,094</b>
<b>Total equity and liabilities</b>		<b>\$234,555</b>	<b>\$(785)</b>	<b>\$233,770</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 Sept 30, 2010 was a **decrease in the insurance recoveries receivable of \$20.1 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 \$0.1 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.

- c. Adjustments to property, plant and equipment as well as E&E expenditures were as follows:
- i. E&E 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, E&E expenditures incurred during the nine months ended September 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 \$169.1 million with an associated increase in E&E expenditures.**
  - 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 nine months ended September 30, 2010 after conversion to IFRS. **The net effect was a decrease in E&E 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 E&E 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 nine months ended September 30, 2010 resulted in a **decrease in E&E expenditures of \$0.7 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 nine months ended September 30, 2010 resulted in an overall increase in the provision for decommissioning obligations of \$0.1 million. Accordingly, this resulted in a **\$0.1 million corresponding increase in E&E 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 \$20.1 million for E&E expenditures.**
  - vi. **The total net impact of items (i) through (v) was an increase in exploration and evaluation assets of \$188.4 million,** including other minor adjustments of \$0.1 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 nine months ended September 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 also impacted by a reduction in expense associated with estimated forfeitures associated with unvested options which were not estimated under previous GAAP. **The net effect at September 30, 2010 was a decrease in contributed surplus of \$0.1 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 nine months ended September 30, 2010 was an increase in the accumulated deficit of \$0.3 million.
  - iv. Due to the timing difference between IFRS and previous GAAP for recognition of the expense associated with share-based payments as well as the impact of estimated forfeitures under IFRS for the nine months ended September 30, 2010, there was a decrease in the accumulated deficit of \$0.3 million.
  - v. **The total impact of items (i) through (iv) was an increase in the accumulated deficit of \$1.1 million as at September 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 E&E expenditures were as follows:

- i. E&E 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, E&E 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 E&E 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 E&E 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 E&E 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 E&E 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 E&E 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 three months ended September 30, 2010 (United States dollars thousands):**

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Revenue</b>				
Interest income		\$ 38	\$ -	\$ 38
<b>Expenses</b>				
General and administrative expenses	a	1,208	(279)	929
Depreciation		132	-	132
Accretion on decommissioning liabilities		4	-	4
Foreign exchange loss		(140)	-	(140)

Total expenses	1,204	(279)	925
<b>Loss before taxation</b>	1,166	(279)	887
<b>Taxation</b>			
Current	(111)	-	(111)
Deferred	43	-	43
<b>Total taxation (recovery)</b>	<b>(68)</b>	<b>-</b>	<b>(68)</b>
<b>Comprehensive loss for the period attributable to shareholders</b>	<b>\$1,098</b>	<b>\$(279)</b>	<b>\$819</b>

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

- a. Adjustments to general and administrative expenses were comprised of the timing difference between IFRS and previous GAAP for recognition of the expense associated with share-based payments as well as the impact of estimated forfeitures under IFRS for the three months ended September 30, 2011, which **resulted in a decrease in general and administrative costs of \$0.3 million.**

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

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Revenue</b>				
Interest income		\$ 74	\$ -	\$ 74
<b>Expenses</b>				
General and administrative expenses	a	4,202	(27)	4,175
Depreciation		443	-	443
Accretion on decommissioning liabilities		11	1	12
Foreign exchange loss		105	-	105
Total expenses		4,761	(26)	4,735
<b>Loss before taxation</b>		4,687	(26)	4,661
<b>Taxation</b>				
Current		(1,014)	-	(1,014)
Deferred		151	-	151
Total taxation (recovery)		(863)	-	(863)
<b>Comprehensive loss for the period attributable to shareholders</b>		\$3,824	\$(26)	\$3,798

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

- a. Adjustments to general and administrative expenses were comprised of the following:
  - 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 nine months ended September 30, 2010 after conversion to IFRS. The net effect was an increase in general and administrative costs of \$0.3 million.
  - ii. Due to the timing difference between IFRS and previous GAAP for recognition of the expense associated with share-based payments as well as the impact of estimated forfeitures under IFRS for the nine months ended September 30, 2011, there was a decrease in the general and administrative costs of \$0.3 million.
  - iii. **The total impact of items (i) and (ii) was negligible.**

**H. 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.**

**I. Reconciliation of statement of cash flows from Canadian GAAP to IFRS for the three months ended September 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	\$ (1,098)	\$211	\$ (887)
Adjustments for				
Depreciation		132	-	132
Accretion on decommissioning liabilities		4	-	4
Share based payments		385	(279)	106
Future income tax expense	b	42	(42)	-
Change in non-cash working capital	c	292	110	402
Net cash from (used in) operating activities		(243)	-	(243)
<b>Cash flow from investing activities</b>				
Expenditure on exploration and evaluation assets	d	-	(23,710)	(23,710)
Expenditure on property, plant, and equipment	e	(20,455)	20,455	-
Insurance recoveries		10,284	-	10,284
Change in non-cash working capital	d	(3,255)	3,255	-
Net cash from (used in) investing activities		(13,426)	-	(13,426)
<b>Cash flow from financing activities</b>				
None		-	-	-
Net cash from (used in) financing activities		-	-	-
<b>Change in cash and cash equivalents</b>				
		(13,669)	-	(13,669)
Cash and cash equivalents, beginning of period		43,769	-	43,769
<b>Cash and cash equivalents, end of period</b>		<b>\$ 30,100</b>	<b>-</b>	<b>\$ 30,100</b>

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

- a. Adjustments to net loss, which total to \$0.2 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 \$0.1 million.
  - ii. Decreased general and administrative expense for timing difference between IFRS and previous GAAP for recognition of the expense associated with share-based payments as well as the impact of estimated forfeitures under IFRS resulted in a decreased net loss of \$0.3 million
  - iii. **Total net effect of items (i) through (ii) is a decreased net loss of \$0.2 million.**
- b. 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.**
- c. Adjustment to change in non-cash working capital was due to the presentation of net loss under IFRS 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 \$0.1 million.
- d. The net change in E&E expenditures is as follows:

- i. Reclassification of expenditures on property, plant and equipment of \$20.5 million.
  - ii. 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**.
  - iii. **The net effect of items (i) through (ii) results in an increase in E&E expenditures of \$23.7 million, including other minor adjustments of \$0.1 million.**
- e. **Expenditures for property, plant and equipment were reclassified as E&E expenditures, net effect was a decrease of \$20.5 million.**

**J. Reconciliation of statement of cash flows from Canadian GAAP to IFRS for the nine months ended September 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	\$ (3,824)	\$(837)	\$ (4,661)
Adjustments for				
Depreciation		443	-	443
Accretion on decommissioning liabilities		11	1	12
Share based payments		880	(287)	593
Income tax recovered (paid)	b	-	598	598
Future income tax expense	c	151	(151)	-
Change in non-cash working capital	d	(273)	416	143
Net cash from (used in) operating activities		(2,612)	(260)	(2,872)
<b>Cash flow from investing activities</b>				
Expenditure on exploration and evaluation assets	e	-	(59,400)	(59,400)
Expenditure on property, plant, and equipment	f	(49,830)	49,830	-
Insurance recoveries		15,664	-	15,664
Change in non-cash working capital	e	(9,830)	9,830	-
Net cash from (used in) investing activities		(43,996)	260	(43,736)
<b>Cash flow from financing activities</b>				
None		-	-	-
Net cash from (used in) financing activities		-	-	-
<b>Change in cash and cash equivalents</b>				
		(46,608)	-	(46,608)
Cash and cash equivalents, beginning of period		76,708	-	76,708
<b>Cash and cash equivalents, end of period</b>		<b>\$ 30,100</b>	<b>-</b>	<b>\$ 30,100</b>

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

- a. Adjustments to net loss, which total to \$(0.8) 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 \$0.9 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. Decreased general and administrative expense for timing difference between IFRS and previous GAAP for recognition of the expense associated with share-based payments as well as the impact of estimated forfeitures under IFRS resulted in a decreased net loss of \$0.3 million
  - iv. **Total net effect of items (i) through (iii) is an increased net loss of \$0.8 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 \$1.0 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 \$0.4 million.**
- e. The net change in E&E expenditures is as follows:
- i. Reclassification of expenditures on property, plant and equipment of \$49.8 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 E&E expenditures of \$59.4 million,** including other minor adjustments of \$0.1 million.
- f. **Expenditures for property, plant and equipment were reclassified as E&E expenditures, net effect was a decrease of \$49.8 million.**

**K. 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 E&E 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 E&E expenditures of \$66.6 million.**
- g. **Expenditures for property, plant and equipment were reclassified as E&E 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>David Cook</b> Executive officer and Head of Oil &amp; Gas TAQA Abu Dhabi, United Arab Emirates</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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