



## **Consolidated Financial Statements**

**For the years ended December 31, 2017 and 2016**

## Management's Report

### Management's Responsibility on Consolidated Financial Statements

Management is responsible for the preparation of the accompanying consolidated financial statements. The consolidated financial statements have been prepared in accordance with the accounting policies detailed in the notes thereto. In Management's opinion, the consolidated financial statements are in accordance with International Financial Reporting Standards, have been prepared within acceptable limits of materiality, and have utilized supportable, reasonable estimates.

Management is responsible for the integrity of the consolidated financial statements. We ensure that the financial statements are prepared by qualified personnel, and that our organizational structure provides appropriate delegation of authority and division of responsibilities. Our policies and procedures are communicated throughout the organization including a written ethics and integrity policy that applies to all employees including the chief executive officer and chief financial officer.

The Board of Directors approves the consolidated financial statements. Their financial statement related responsibilities are fulfilled mainly through the Audit Committee. The Audit Committee is composed of a majority of independent directors, all with financial expertise. The Audit Committee meets regularly with Management and the external auditors to discuss reporting and control issues and ensures each party is properly discharging its responsibilities. The Audit Committee also considers the independence of the external auditors and reviews their fees.

Deloitte LLP ("Deloitte"), an independent firm of professional chartered accountants, was appointed by the shareholders to audit the consolidated financial statements of the Company and to provide an independent professional opinion. Deloitte's audit opinion is attached to these consolidated financial statements.

*"Signed"*

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Cody Smith, Chief Operating Officer and Interim Chief Executive Officer

*"Signed"*

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Aaron Thompson, Chief Financial Officer

March 28, 2018



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## Independent Auditor's Report

To the Shareholders of Strategic Oil & Gas Ltd.

We have audited the accompanying consolidated financial statements of Strategic Oil & Gas Ltd., which comprise the consolidated balance sheets as at December 31, 2017 and 2016, and the consolidated statements of net income (loss) and comprehensive income (loss), consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

### Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

### Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Strategic Oil & Gas Ltd. as at December 31, 2017 and 2016, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

### Emphasis of Matter

Without qualifying our opinion, we draw attention to Note 2 to the consolidated financial statements which describe matters and conditions that indicate the existence of material uncertainties that may cast significant doubt about Strategic Oil & Gas Ltd.'s ability to continue as a going concern.

Chartered Professional Accountants  
March 28, 2018  
Calgary, Alberta

# Strategic Oil & Gas Ltd.

## Consolidated balance sheets

| (\$000)   | Note | December 31, 2017 | December 31, 2016 |
|---|------|-------------------|-------------------|
| <b>Assets</b>                                     |      |                   |                   |
| Current assets                                    |      |                   |                   |
| Cash and cash equivalents                         |      | \$ 13,138         | \$ 50,802         |
| Term deposits                                     | 4    | 4,522             | 4,667             |
| Inventory   |      | 159               | 108               |
| Trade and other receivables                       |      | 4,011             | 3,580             |
|   |      | <b>21,830</b>     | 59,157            |
| Property, plant, and equipment, net               | 6,7  | 155,108           | 175,073           |
| Exploration and evaluation assets                 | 5,7  | 9,651             | 14,438            |
| <b>Total Assets</b>                               |      | <b>\$ 186,589</b> | <b>\$ 248,668</b> |
| <b>Liabilities</b>                                |      |                   |                   |
| Current Liabilities:                              |      |                   |                   |
| Accounts payable and accrued liabilities          |      | \$ 5,553          | \$ 5,760          |
| Accrued interest on convertible debentures        |      | 2,836             | 2,633             |
| Decommissioning liabilities                       | 9    | 3,190             | 3,441             |
|   |      | <b>11,579</b>     | 11,834            |
| Convertible debentures                            | 8    | 94,323            | 84,489            |
| Decommissioning liabilities                       | 9    | 59,303            | 49,210            |
| <b>Total Liabilities</b>                          |      | <b>\$ 165,205</b> | <b>\$ 145,533</b> |
| <b>Shareholders' Equity</b>                       |      |                   |                   |
| Share capital                                     | 10   | 365,466           | 360,073           |
| Equity component of convertible debentures        | 8    | 10,247            | 9,878             |
| Contributed surplus                               |      | 13,052            | 11,063            |
| Deficit   |      | (367,381)         | (277,879)         |
|   |      | <b>\$ 21,384</b>  | <b>\$ 103,135</b> |
| <b>Total Liabilities and Shareholders' Equity</b> |      | <b>\$ 186,589</b> | <b>\$ 248,668</b> |

See accompanying notes to the consolidated financial statements

Commitments and contingencies (Note 19)

Approved by the Board of Directors

"Signed"

Tom Clausus

"Signed"

Rodger Hawkins

# Strategic Oil & Gas Ltd.

## Consolidated statements of net income (loss) and comprehensive income (loss)

| Year ended December 31<br>(\$000, except per share amounts) | Note  | 2017               | 2016             |
|---|-------|--------------------|------------------|
| <b>Revenue</b>  |       |                    |                  |
| Petroleum and natural gas sales                             |       | \$ 37,867          | \$ 23,878        |
| Royalties   |       | (4,222)            | (3,283)          |
| Revenues, net of royalties                                  |       | 33,645             | 20,595           |
| Finance income  |       | 355                | 216              |
|   |       | <b>34,000</b>      | <b>20,811</b>    |
| <b>Expenses</b>   |       |                    |                  |
| Operating   |       | 18,714             | 14,320           |
| Transportation  |       | 988                | 559              |
| General and administrative                                  |       | 5,742              | 5,007            |
| Finance costs   | 12    | 12,383             | 10,313           |
| Stock-based compensation                                    | 11    | 2,006              | 509              |
| Depletion, depreciation and amortization                    |       | 17,817             | 13,132           |
| Impairment charge (reversal)                                | 6,7   | 58,800             | (52,733)         |
| Revaluation on decommissioning liabilities                  | 9     | 7,190              | -                |
| Change in fair value of conversion option                   |       | -                  | 278              |
| Gain on disposal of property, plant and equipment           |       | -                  | (40)             |
|   |       | <b>123,640</b>     | <b>(8,655)</b>   |
| <b>Operating income (loss) before taxes</b>                 |       | <b>(89,640)</b>    | 29,466           |
| Deferred tax recovery                                       | 13    | 138                | 3,776            |
| <b>Net income (loss) and comprehensive income (loss)</b>    |       | <b>\$ (89,502)</b> | <b>\$ 33,242</b> |
| <b>Net income (loss) per weighted average share</b>         | 10(c) |                    |                  |
| Basic   |       | \$ (1.94)          | \$ 1.21          |
| Diluted   |       | (1.94)             | 0.55             |

See accompanying notes to the consolidated financial statements

# Strategic Oil & Gas Ltd.

## Consolidated statements of changes in shareholders' equity

For the years ended December 31, 2017 and 2016

| (\$000)  | Note | Share<br>Capital  | Convertible<br>Debenture<br>Equity Component | Contributed<br>Surplus | Deficit             | Total equity      |
|--|------|-------------------|--|------------------------|---------------------|-------------------|
| <b>Balance Jan 1, 2017</b>                             |      | <b>\$ 360,073</b> | <b>\$ 9,878</b>                              | <b>\$ 11,063</b>       | <b>\$ (277,879)</b> | <b>\$ 103,135</b> |
| Shares issued  | 10   | 5,750             | -  | -                      | -                   | 5,750             |
| Share issue costs                                      | 10   | (411)             | -  | -                      | -                   | (411)             |
| Stock options exercised                                | 10   | 49                | -  | (17)                   | -                   | 32                |
| Debentures converted                                   | 10   | 5                 | -  | -                      | -                   | 5                 |
| Stock based compensation                               | 11   | -                 | -  | 2,006                  | -                   | 2,006             |
| Equity component of convertible debentures, net of tax | 8    | -                 | 369  | -                      | -                   | 369               |
| Net loss   |      | -                 | -  | -                      | (89,502)            | (89,502)          |
| <b>Balance December 31, 2017</b>                       |      | <b>\$ 365,466</b> | <b>\$ 10,247</b>                             | <b>\$ 13,052</b>       | <b>\$ (367,381)</b> | <b>\$ 21,384</b>  |

| (\$000)  | Note | Share<br>Capital  | Convertible<br>Debenture<br>Equity Component | Contributed<br>Surplus | Deficit             | Total equity      |
|--|------|-------------------|--|------------------------|---------------------|-------------------|
| <b>Balance Jan 1, 2016</b>                             |      | <b>\$ 319,678</b> | <b>\$ -</b>                                  | <b>\$ 10,558</b>       | <b>\$ (311,121)</b> | <b>\$ 19,115</b>  |
| Stock options exercised                                | 10   | 13                | -  | (4)                    | -                   | 9                 |
| Shares issued  | 10   | 40,453            | -  | -                      | -                   | 40,453            |
| Share issue costs                                      | 10   | (75)              | -  | -                      | -                   | (75)              |
| Debentures converted                                   | 10   | 4                 | -  | -                      | -                   | 4                 |
| Stock based compensation                               | 11   | -                 | -  | 509                    | -                   | 509               |
| Equity component of convertible debentures, net of tax | 8    | -                 | 9,878  | -                      | -                   | 9,878             |
| Net income   |      | -                 | -  | -                      | 33,242              | 33,242            |
| <b>Balance December 31, 2016</b>                       |      | <b>\$ 360,073</b> | <b>\$ 9,878</b>                              | <b>\$ 11,063</b>       | <b>\$ (277,879)</b> | <b>\$ 103,135</b> |

See accompanying notes to the consolidated financial statements

# Strategic Oil & Gas Ltd.

## Consolidated statements of cash flows

| Year Ended December 31<br>(\$000)                                       | Note | 2017             | 2016             |
|---|------|------------------|------------------|
| <b>Operating activities:</b>  |      |                  |                  |
| Net income (loss) for the year  |      | \$ (89,502)      | \$ 33,242        |
| Non-cash items:   |      |                  |                  |
| Depletion, depreciation, and amortization                               |      | 17,817           | 13,132           |
| Stock-based compensation  |      | 2,006            | 509              |
| Change in fair value of conversion option                               |      | -                | 278              |
| Impairment charge (reversal)  |      | 58,800           | (52,733)         |
| Revaluation on decommissioning liabilities                              |      | 7,190            | -                |
| Deferred tax recovery   |      | (138)            | (3,776)          |
| Non-cash finance costs  | 12   | 11,892           | 9,169            |
| Gain on disposal of property, plant and equipment                       |      | -                | (40)             |
| Expenditures on decommissioning liabilities                             | 9    | (2,333)          | (1,625)          |
| Changes in non-cash working capital                                     | 14   | (1,214)          | 5,179            |
| <b>Cash provided by operating activities</b>                            |      | <b>4,518</b>     | <b>3,335</b>     |
| <b>Financing activities:</b>  |      |                  |                  |
| Issue of common shares, net of share issuance costs                     |      | 5,339            | 40,378           |
| Exercise of options   |      | 32               | 9                |
| Issue of debentures, net of transaction costs                           | 8    | (49)             | 92,556           |
| Decrease in bank loan   |      | -                | (42,857)         |
| Repayment of promissory notes   |      | -                | (10,000)         |
| Changes in non-cash working capital                                     | 14   | (5)              | (26)             |
| <b>Cash provided by financing activities</b>                            |      | <b>5,317</b>     | <b>80,060</b>    |
| <b>Investing activities:</b>  |      |                  |                  |
| Expenditures – property, plant and equipment                            |      | (48,094)         | (24,832)         |
| Expenditures – exploration and evaluation assets                        |      | (106)            | (4,447)          |
| Redemption (investment) in term deposits                                |      | 145              | (4,667)          |
| Proceeds on disposal of property, plant and equipment                   |      | -                | 15               |
| Changes in non-cash working capital                                     | 14   | 556              | 1,335            |
| <b>Cash used in investing activities</b>                                |      | <b>(47,499)</b>  | <b>(32,596)</b>  |
| <b>(Decrease) increase in cash and cash equivalents during the year</b> |      | <b>(37,664)</b>  | <b>50,799</b>    |
| <b>Cash and cash equivalents, beginning of the year</b>                 |      | <b>50,802</b>    | <b>3</b>         |
| <b>Cash and cash equivalents, end of the year</b>                       |      | <b>\$ 13,138</b> | <b>\$ 50,802</b> |

See accompanying notes to the consolidated financial statements

# Strategic Oil & Gas Ltd.

Notes to the consolidated financial statements

December 31, 2017 and 2016

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## 1. Corporate information

Strategic Oil & Gas Ltd. (“Strategic”) is a company registered and domiciled in Alberta. Strategic is a publicly traded company whose shares are listed on the TSX Venture Exchange. Strategic, together with its subsidiaries, (collectively referred to as the “Company”) is engaged in the exploration for and development of petroleum and natural gas reserves in Western Canada with insignificant operations in the Western United States. The Company is headquartered in Canada at Suite 1100, 645 – 7th Avenue SW, Calgary, Alberta.

## 2. Basis of presentation

### a) Going concern

These consolidated financial statements have been prepared on a going concern basis. The going concern basis of presentation assumes that the Company will continue in operation for the foreseeable future and will be able to realize its assets and discharge its liabilities and commitments in the normal course of business. For the year ended December 31, 2017, the Company reported positive cash flow from operating activities of \$4.5 million, a net loss of \$89.5 million and an accumulated deficit of \$367.4 million. Sustained low commodity prices in recent years have put pressure on the Company’s cash flows.

At December 31, 2017, the Company had \$13 million in cash and a positive working capital of \$10.3 million. Cash from operating activities is dependent on future commodity prices and production levels. In order to continue funding future capital programs, the Company will need to obtain additional equity or debt financing, or assess other options. The ability to access the required capital to maintain current production levels and cash flows is dependent on a variety of external factors. This material uncertainty may cast significant doubt upon the Company’s ability to continue as a going concern.

The consolidated financial statements do not reflect adjustments that would be necessary if the going concern basis was not appropriate. The appropriateness of the going concern basis is dependent upon, among other things, the ability to obtain debt or equity financing, or other sources of funding for future capital programs.

### b) Statement of compliance

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) issued and outstanding as of December 31, 2017, and were prepared using accounting policies that are compliant with these standards. Certain prior year comparative figures have been reclassified to conform to the current year’s presentation. The reclassifications include separation of accrued interest on convertible debentures from accounts payable and current liabilities on the consolidated balance sheet, and removal of the funds (used in) from operations sub-total from the consolidated statement of cash flows.

These consolidated financial statements were approved by the Company’s Board of Directors on March 28, 2018.

### c) Basis of measurement

These consolidated financial statements have been prepared on a historical cost basis except for cash and cash equivalents and certain share-based payment transactions, which are measured at fair value.

### d) Share consolidation

Effective March 6, 2017 the Company’s common shares were consolidated on the basis of one new share for twenty old shares (1:20) in the capital of the Company. All information regarding the issued, issuable and outstanding common shares, options and weighted average number and per share information has been retrospectively restated to reflect the twenty to one consolidation.

# Strategic Oil & Gas Ltd.

Notes to the consolidated financial statements

December 31, 2017 and 2016

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## e) Functional and presentation currency

These consolidated financial statements are presented in Canadian dollars, the Company's functional currency.

## f) Estimates and judgments

The timely preparation of the consolidated financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses for the period. Actual results may differ from these estimates. Information regarding the significant judgments made by management in applying the Company's accounting policies and the key sources of estimation uncertainty are outlined below.

The Company uses estimates of oil and natural gas reserves in the calculation of depreciation and depletion and also determination of the recoverable amount for value in use and fair value less costs to sell ("FVLCS") calculations of non-financial assets. By their nature, the estimates of reserves, including estimates of price, costs, discount rates and the related future cash flows, are subject to measurement uncertainty.

The recoverability of the carrying value of oil and gas properties is assessed at the cash generating unit ("CGU") level. Determination of the properties and other assets to be included within a particular CGU is based on management's judgment with respect to the integration between assets, shared infrastructure and cash flows. Changes in the assets comprising each CGU impacts recoverable amounts used in impairment assessments and could have a material impact on net income. Strategic conducts its operations through 4 CGUs, namely Steen/Marlowe, Bistcho, other Canadian and USA.

Evaluating potential impairment of exploration and evaluation assets, as well as recoverable amounts, requires the use of assumptions an management's judgement and changes in these assumptions could have a material impact on net income.

The transfer of exploration and evaluation assets to property, plant and equipment is based on estimated reserves used in the determination of an asset's technical feasibility and commercial viability.

Amounts recorded for decommissioning obligations and the associated accretion are calculated based on estimates of asset retirement costs, timing of expenditures, risk free interest rates, site remediation and related cash flows.

The determination of fair value of stock-based compensation is based on estimates using the Black-Scholes option pricing model which requires estimates of assumptions such as volatility, risk free interest rate, forfeiture rate, and expected option life.

Tax interpretations, regulations and legislation in the various jurisdictions in which the Company operates are subject to change. Income taxes are subject to measurement uncertainty, the timing and likelihood of any recognition of deferred tax assets, which are assessed by management at the end of the reporting period to determine the likelihood that they will be realized from future taxable earnings.

# Strategic Oil & Gas Ltd.

Notes to the consolidated financial statements

December 31, 2017 and 2016

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## 3. Significant accounting policies

### a) Basis of consolidation

#### Subsidiaries

The consolidated financial statements include the accounts of Strategic and its wholly-owned subsidiaries as follows:

| <b>Subsidiary</b>           | <b>Jurisdiction</b>   | <b>Nature of operations</b>               |
|-----------------------------|-----------------------|---|
| Strategic Oil & Gas Ltd.    | Alberta               | Parent company                            |
| Strategic Oil & Gas, Inc.   | Wyoming, USA          | US oil and gas exploration and operations |
| Jed Oil (USA), Inc.         | Wyoming, USA          | US holding company                        |
| Strategic Transmission Ltd. | Northwest Territories | Holding company                           |

Subsidiaries are fully consolidated from the date of acquisition, being the date on which the Company obtains control, and continue to be consolidated until the date that such control ceases. Control exists when the Company has the power to govern the relevant activities of an entity so as to obtain benefits from those activities. The financial statements of the subsidiaries are prepared using consistent accounting policies and for the same reporting period as the parent. All inter-company balances and transactions are eliminated on consolidation.

#### Joint arrangements

The Company conducts some of its oil and gas production activities through jointly controlled operations and the consolidated financial statements reflect only the Company's proportionate interest in such activities. Joint control exists for contractual arrangements governing the Company's assets whereby the Company has less than 100 per cent working interest, all of the partners have control of the arrangement collectively, and spending on the project requires unanimous consent of all parties that collectively control the arrangement and share the associated risks. The Company does not have any joint arrangements that are individually material to the Company or that are structured through joint venture arrangements.

### b) Financial instruments

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or when the Company has transferred substantively all the risks and rewards of ownership.

Financial assets and liabilities are offset and the net amount reported in the consolidated balance sheet when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

Subsequent measurement depends upon the classification of the financial instrument as one of:

- Fair value through profit or loss
- Loans and receivables
- Available for sale
- Held to maturity
- Other financial liabilities

# Strategic Oil & Gas Ltd.

Notes to the consolidated financial statements

December 31, 2017 and 2016

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## Financial instruments at fair value through profit or loss

An instrument is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Financial instruments and financial risk management are designated at fair value through profit or loss if the Company makes purchase and sale decisions based on their fair value in accordance with the Company's documented risk management strategy. Upon initial recognition, any transaction costs attributable to the financial instruments are recognized through earnings when incurred. Financial instruments at fair value through profit or loss are measured at fair value, and changes therein are recognized in earnings.

## Derivative financial instruments

The Company has entered into certain financial derivative contracts in order to reduce its exposure to market risks from fluctuations in commodity prices. These instruments are not used for trading or speculative purposes. The Company has not designated its financial derivative contracts as effective accounting hedges, and thus has not applied hedge accounting, even though the Company considers all commodity contracts to be economic hedges. As a result, all financial derivative contracts are classified as fair value through profit or loss and are recorded on the balance sheet at fair value. Attributable transaction costs are recognized in earnings when incurred. The estimated fair value of all derivative instruments is based on quoted market prices and/or third party market indications and forecasts.

Financial instruments classified as "loans and receivables", "held to maturity", or "financial liabilities measured at amortized cost" are subsequently measured at amortized cost using the effective interest method of amortization.

Financial assets classified as "available for sale" are measured at fair value, with the changes in fair value recognized in other comprehensive income.

The Company's financial assets and financial liabilities are classified and measured as follows:

| Financial instrument                     | Classification                    | Subsequent measurement |
|--|-----------------------------------|------------------------|
| Cash and cash equivalents                | Fair value through profit or loss | Fair value             |
| Trade and other receivables              | Loans and receivables             | Amortized cost         |
| Accounts payable and accrued liabilities | Other financial liabilities       | Amortized cost         |
| Bank indebtedness                        | Other financial liabilities       | Amortized cost         |
| Convertible debentures – debt component  | Other financial liabilities       | Amortized cost         |
| Risk management contracts                | Fair value through profit or loss | Fair value             |

## c) Exploration and evaluation assets

The Company accounts for exploration and evaluation of petroleum and natural gas property ("E&E") costs in accordance with IFRS 6 "Exploration for and Evaluation of Mineral Resources". Costs incurred are classified as E&E costs when they relate to exploring and evaluating a property for which the Company has the license or right to explore and extract resources.

# Strategic Oil & Gas Ltd.

Notes to the consolidated financial statements

December 31, 2017 and 2016

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Pre-license costs are recognized in the statement of comprehensive income (loss) as incurred. E&E costs, including the costs of acquiring undeveloped land, geological and geophysical costs, sampling and appraisals and related drilling costs are initially capitalized until the drilling of the well is complete and the results have been evaluated. The technical feasibility and commercial viability of extracting a mineral resource is considered to be determinable when proved or probable reserves are determined to exist. If proved and/or probable reserves are found, the accumulated costs are tested for impairment and the carrying value net of any impairment is transferred to property, plant and equipment. Undeveloped land costs are amortized over the initial lease term; other E&E costs are not amortized.

E&E assets are assessed for impairment if (i) sufficient data exists to determine technical feasibility and commercial viability, and (ii) facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

## d) Property, plant and equipment

### Development and production costs

The Company recognized property, plant and equipment ("PPE") assets at cost less accumulated depletion, depreciation and impairment losses.

Items of property, plant and equipment, which include oil and natural gas development and production assets, costs incurred in acquiring, developing proved and/or probable reserves and bringing on or enhancing production from such reserves are measured at cost less accumulated depletion and depreciation and accumulated impairment losses. The cost of development and production assets includes: transfers from E&E assets, which generally includes the cost of land and seismic upon determination of technical feasibility and commercial viability; the cost to drill, complete and tie-in the wells; facility costs; the cost of recognizing provisions for future restoration and decommissioning; property acquisitions; and directly attributable overheads. Repairs and maintenance and operational costs that do not extend or enhance the recoverable reserves are charged to profit or loss when incurred.

The costs of planned major overhaul, turnaround activities and equipment replacement that maintain PPE and benefit future years of operations are capitalized. Recurring planned maintenance activities performed on shorter intervals are expensed as operating costs. Replacements outside of a major overhaul or turnaround are capitalized when it is probable that future economic benefits will flow to the Company and the associated carrying amount of the replaced asset (or part of a replaced asset) is derecognized.

Development and production assets are grouped into CGUs for impairment testing and depletion calculations.

Gains and losses on disposal of an item of property, plant and equipment, including oil and natural gas interests, are determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment and are recognized in the statements of net income (loss) and comprehensive income (loss).

### Depletion and depreciation

The net carrying value of development and production assets is depleted using the unit of production method by reference to the ratio of production in the period to the related proved plus probable reserves, taking into account estimated future development costs necessary to bring those reserves into production and the estimated salvage value of the assets at the end of their useful lives. Natural gas reserves and production are converted at the energy equivalent conversion ratio of six thousand cubic feet of natural gas to one barrel of oil, reflecting the approximate energy content. Where significant parts of an item of property, plant, and equipment have different lives than the oil and gas reserves, they are accounted for as separate items (major components) and depreciated over the expected life of the component.

# Strategic Oil & Gas Ltd.

## Notes to the consolidated financial statements

December 31, 2017 and 2016

Proved plus probable reserves are estimated annually by independent qualified reserve evaluators and represent the estimated quantities of crude oil, natural gas and natural gas liquids which geological, geophysical and engineering data demonstrate with a specified degree of certainty to be recoverable in future years from known reservoirs and which are considered commercially producible. The estimated useful lives for certain production assets for the current and comparative years are as follows:

|  |                           |
|--|---------------------------|
| Development and production assets        | Unit of Production        |
| Corporate assets                         | Straight Line - 5 years   |
| Major components                         | Straight Line - 20 years  |
| Major overhaul and turnaround activities | Straight Line – 2-5 years |

### e) Impairment

#### Financial assets

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount and the present value of the estimated future cash flows discounted at the original effective interest rate.

Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.

All impairment losses are recognized in the consolidated statements of net income (loss) and comprehensive income (loss).

An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized. For financial assets measured at amortized cost the reversal is recognized in profit or loss.

#### Non-financial assets

The carrying amounts of the Company's non-financial assets, other than E&E assets and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment at the CGU level. If any such indication exists, then the carrying value of each CGU, net of decommissioning obligations, including goodwill is compared to its recoverable amount. For goodwill and other intangible assets that have indefinite lives or that are not yet available for use an impairment test is completed each year. E&E assets are allocated to related CGU's when they are assessed for impairment, both at the time of any triggering facts and circumstances as well as upon their eventual reclassification to producing assets (oil and natural gas interests in property, plant and equipment).

The recoverable amount of an asset or a CGU is the greater of its value in use and its fair value less costs to sell. The recoverable amount also includes a provision for the estimated net present value of decommissioning obligations.

In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Value in use is generally computed by reference to the present value of the future cash flows expected to be derived from production of proven and probable reserves which are based on forecast prices and costs. Fair value less costs to sell is determined to be the amount for which the asset could be sold in an arm's length transaction.

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An impairment loss is recognized if the carrying amount of an asset or its CGU, net of related decommissioning obligations exceeds its estimated recoverable amount. Impairment losses are recognized in the consolidated statements of net income (loss) and comprehensive income (loss). Impairment losses recognized in respect of CGU's are allocated first to reduce the carrying amount of any goodwill allocated to the CGUs and then to reduce the carrying amounts of the other assets in the CGU on a pro rata basis.

An impairment loss in respect of goodwill is not reversed. In respect of other assets, impairment losses recognized in prior years are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depletion and depreciation or amortization, if no impairment loss had been recognized.

## f) Provisions

A provision is recognized if, as a result of a past event, the Company has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a risk free interest rate. Provisions are not recognized for future operating losses.

### **Decommissioning liabilities**

The Company's activities give rise to dismantling, decommissioning and site disturbance remediation activities. Provision is made for the estimated cost of site restoration and capitalized in the relevant asset category.

Decommissioning liabilities are measured at the present value of management's best estimate of expenditure required to settle the present obligation at the balance sheet date. Subsequent to the initial measurement, the obligation is adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. The increase in the provision due to the passage of time is recognized as finance costs whereas increases/decreases due to changes in the estimated future cash flows or changes in discount rate are capitalized and amortized over the same period as the underlying asset. Actual costs incurred upon settlement of the decommissioning obligations are charged against the provision to the extent a provision was established.

## g) Income tax

Income tax expense (recovery) comprises current tax and deferred tax. Income tax expense (recovery) is recognized in comprehensive income (loss) except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized on the initial recognition of assets or liabilities in a transaction that is not a business combination. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted as of the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

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A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

## **h) Flow-through common shares**

Periodically, the Company finances a portion of its exploration and development activities through the issuance of flow-through shares. The resource expenditure deductions for income tax purposes related to exploratory development activities are renounced to investors in accordance with tax legislation. Flow-through shares issued are recorded in share capital at the fair value of common shares on the date of issue. The premium received on issuing flow-through shares is initially recorded as a liability. As qualifying expenditures are incurred, the premium is reversed and a deferred tax liability is recorded. Any difference between the issuance premium and the deferred tax liability is recognized as deferred tax expense/recovery.

## **i) Earnings per share**

Basic earnings per share ("EPS") is calculated by dividing the net loss (income) for the year attributable to equity owners of the Company by the weighted average number of common shares outstanding during the year.

Diluted EPS is calculated by adjusting the weighted average number of common shares outstanding for dilutive instruments. The number of shares included with respect to options, and similar instruments is computed using the treasury stock method. The Company's potentially dilutive instruments include stock options and convertible debentures.

## **j) Finance income and expenses**

Finance expense comprises interest expense on borrowings, accretion of the discount on debentures and promissory notes and decommissioning liabilities and impairment losses recognized on financial assets.

Borrowing costs incurred for the construction of qualifying assets are capitalized during the period of time that is required to complete and prepare the assets for their intended use or sale. All other borrowing costs are recognized in comprehensive income (loss) using the effective interest method. The capitalization rate used to determine the amount of borrowing costs to be capitalized is the weighted average interest rate applicable to the Company's outstanding borrowings during the period.

Interest income is recognized as it accrues in the consolidated statements of net income (loss) and comprehensive income (loss).

## **k) Revenue recognition**

Revenue from the sale of oil and natural gas is recognized when the significant risks and rewards of ownership is transferred, which is generally when title passes to the customer in accordance with the terms of the sales contract. Revenue from the production of oil and natural gas from properties in which the Company has an interest with other producers is recognized on the Company's net working interest only.

# Strategic Oil & Gas Ltd.

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## l) Inventory

Inventory of crude oil, consisting of production for which title has not yet transferred to the buyer, is valued at the lower of cost or net realizable value, based on per barrel weighted average cost of production.

## m) New accounting policies

### Future Accounting Policy Changes

#### *IFRS 15 Revenue from Contracts with Customers*

In April 2016, the IASB issued its final amendments to IFRS 15 “Revenue from Contracts with Customers,” which replaces IAS 18 “Revenue,” IAS 11 “Construction Contracts,” and related interpretations. IFRS 15 provides a single, principles-based five-step model to be applied to all contracts with customers. The standard requires an entity to recognize revenue to reflect the transfer of goods and services for the amount it expects to receive, when control is transferred to the purchaser. Disclosure requirements have also been expanded. The standard is required to be adopted either retrospectively or using a modified retrospective approach for annual periods beginning on or after January 1, 2018, with earlier adoption permitted.

The Company will retrospectively adopt IFRS 15 on January 1, 2018. The Company has completed reviewing its various revenue streams and underlying contracts with customers. It has been concluded that the adoption of IFRS 15 will not have a material impact on the Company’s net loss and financial position. The Company will expand disclosures in the notes to its consolidated financial statements as prescribed by IFRS 15.

#### *IFRS 9 Financial Instruments*

In July 2014, the IASB completed the final elements of IFRS 9 “Financial Instruments.” The standard supersedes earlier versions of IFRS 9 and completes the IASB’s project to replace IAS 39 “Financial Instruments: Recognition and Measurement.” IFRS 9 introduces a single approach to determine whether a financial asset is measured at amortized cost or fair value and replaces the multiple rules in IAS 39. The approach is based on how an entity manages its financial instruments in the context of its business model and the contractual cash flow characteristics of the financial assets. For financial liabilities, IFRS 9 retains most of the requirements of IAS 39. The Company anticipates that adoption of IFRS 9 will result in changes to the classification of the Company’s financial assets but will not change the classification of the Company’s financial liabilities. The Company does not anticipate any material changes in the carrying values of the Company’s financial instruments as a result of the adoption of IFRS 9. The Company does not anticipate that the new impairment model will result in material changes to the valuation of its financial assets on adoption of IFRS 9.

In addition, IFRS 9 introduces a new expected credit loss model for calculating impairment of financial assets, replacing the incurred loss model required by IAS 39. The Company has determined that the new impairment model will not result in material changes to the valuation of its financial assets on adoption of IFRS 9. IFRS 9 also contains a new model to be used for hedge accounting. The Company does not currently intend to apply hedge accounting to any of its risk management contracts on adoption of IFRS 9. The standard will come into effect for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. IFRS 9, as well as consequential amendments to IFRS 7, “Financial Instruments: Disclosures”, will be applied on a retrospective basis by the Company on January 1, 2018.

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## IFRS 16 Leases

In January 2016, the IASB issued IFRS 16 “Leases,” which replaces IAS 17 “Leases.” For lessees applying IFRS 16, a single recognition and measurement model for leases would apply, with required recognition of assets and liabilities for most leases. The standard will come into effect for annual periods beginning on or after January 1, 2019, with earlier adoption permitted if the entity is also applying IFRS 15 “Revenue from Contracts with Customers.” The standard is required to be adopted either retrospectively or using a modified retrospective approach. IFRS 16 will be applied by the Company on January 1, 2019 and the Company is currently evaluating the impact of the standard on the Company's consolidated financial statements.

## 4. Term deposits

The Company has pledged term deposits maturing in January and February 2018 as collateral with a chartered bank for \$4.5 million (December 31, 2016 - \$4.7 million) in outstanding letters of credit issued to support end-of-life obligations for the Company's assets in Cameron Hills, NWT. These term deposits will be released upon extinguishment of the related letters of credit.

## 5. Exploration and evaluation (“E&E”) assets

| (\$000)                                       | December 31, 2017 | December 31, 2016 |
|---|-------------------|-------------------|
| Opening balance                               | \$ 14,438         | \$ 11,169         |
| E&E expenditures                              | 106               | 4,447             |
| E&E transfer to property, plant and equipment | (1,407)           | (11)              |
| E&E impairment (Note 7)                       | (2,900)           | -                 |
| Amortization                                  | (586)             | (1,167)           |
| Closing balance                               | \$ 9,651          | \$ 14,438         |

## 6. Property, plant, and equipment (“PPE”)

| (\$000)  |                   |                 |                   |  |
|--|-------------------|-----------------|-------------------|--|
| Carrying value before accumulated depletion, depreciation and impairment | D&P Assets        | Office          | Total             |  |
| As at December 31, 2016  | \$ 475,529        | \$ 1,171        | \$ 476,700        |  |
| Additions  | 48,087            | 7               | 48,094            |  |
| E&E transfer   | 1,407             | -               | 1,407             |  |
| Change in decommissioning liabilities estimates                          | 3,693             | -               | 3,693             |  |
| <b>As at December 31, 2017</b>   | <b>\$ 528,716</b> | <b>\$ 1,178</b> | <b>\$ 529,894</b> |  |

| (\$000)   |                   |                 |                   |  |
|---|-------------------|-----------------|-------------------|--|
| Accumulated depletion, depreciation and impairment  | D&P Assets        | Office          | Total             |  |
| As at December 31, 2016                             | \$ 300,498        | \$ 1,129        | \$ 301,627        |  |
| Depreciation and depletion                          | 17,191            | 40              | 17,231            |  |
| Depreciation and depletion capitalized to inventory | 28                | -               | 28                |  |
| Impairment charge (Note 7)                          | 55,900            | -               | 55,900            |  |
| <b>As at December 31, 2017</b>                      | <b>\$ 373,617</b> | <b>\$ 1,169</b> | <b>\$ 374,786</b> |  |

| (\$000)                        |                   |             |                   |  |
|--------------------------------|-------------------|-------------|-------------------|--|
| Net carrying value             | D&P Assets        | Office      | Total             |  |
| <b>As at December 31, 2017</b> | <b>\$ 155,099</b> | <b>\$ 9</b> | <b>\$ 155,108</b> |  |

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(\$000)

| <b>Carrying value before accumulated depletion, depreciation and impairment</b> | <b>D&amp;P Assets</b> | <b>Office</b>   | <b>Total</b>      |
|---|-----------------------|-----------------|-------------------|
| As at December 31, 2015   | \$ 451,331            | \$ 1,170        | \$ 452,501        |
| Additions   | 24,831                | 1               | 24,832            |
| E&E transfer  | 11                    | -               | 11                |
| Change in decommissioning liabilities estimates                                 | (644)                 | -               | (644)             |
| <b>As at December 31, 2016</b>  | <b>\$ 475,529</b>     | <b>\$ 1,171</b> | <b>\$ 476,700</b> |

(\$000)

| <b>Accumulated depletion, depreciation and impairment</b> | <b>D&amp;P Assets</b> | <b>Office</b>   | <b>Total</b>      |
|---|-----------------------|-----------------|-------------------|
| As at December 31, 2015                                   | \$ 341,354            | \$ 1,070        | \$ 342,424        |
| Depreciation and depletion                                | 11,906                | 59              | 11,965            |
| Depreciation and depletion capitalized to inventory       | (29)                  | -               | (29)              |
| Net impairment reversal (Note 7)                          | (52,733)              | -               | (52,733)          |
| <b>As at December 31, 2016</b>                            | <b>\$ 300,498</b>     | <b>\$ 1,129</b> | <b>\$ 301,627</b> |

(\$000)

| <b>Net carrying value</b>      | <b>D&amp;P Assets</b> | <b>Office</b> | <b>Total</b>      |
|--------------------------------|-----------------------|---------------|-------------------|
| <b>As at December 31, 2016</b> | <b>\$ 175,031</b>     | <b>\$ 42</b>  | <b>\$ 175,073</b> |

Substantially all of the Company's development and production assets are located within Canada. The cost of PPE includes amounts in respect of the provision for decommissioning obligations. For the year ended December 31, 2017, \$1.0 million of direct general and administrative expenses - related to technical office staff that are directly involved in the Company's capital spending programs, were capitalized to PPE (\$0.9 million for the year ended December 31, 2016).

Future capital costs of \$155.7 million (December 31, 2016 - \$165.7 million) have been included in the depletable balance as at December 31, 2017. Depletion has been calculated using proved plus probable reserves. Major components costs - such as facilities and pipelines, which are depreciated separately, are \$59.3 million (December 31, 2016 - \$57.5 million) with a net carrying value of \$46.0 million (December 31, 2016 - \$47.5 million).

## 7. Impairment charge (reversal)

The Company's exploration, development and production assets are aggregated into CGUs based on their ability to generate largely independent cash flows. The Company identified evidence indicating impairment in the December 31, 2017, carrying value of the development and production assets. This evidence was based on commodity price decreases and asset performance.

The recoverable amount was determined based on the fair value less costs to sell method for reserves as well as resources estimated by management to be realized based on planned future drilling locations not considered in the reserve report. The key assumptions used in determining the recoverable amount include the future cash flows using reserve and resource forecasts, forecasted commodity prices, discount rates, inflation rates and future development costs estimated for reserves by independent reserve engineers and by internal estimates based on historical experiences and trends for planned future drilling locations.

The fair value less costs to sell values used to determine the recoverable amounts of each CGU are classified as Level 3 fair value measures as they are based on the Company's estimate of key assumptions that are not based on observable market data.

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The estimated cash flows were based on future cash flows of proved plus probable reserves discounted at a pre-tax rate of 10 percent (2016 – 10-12 percent). The future cash flows also consider, when appropriate, past capital activities, observable market conditions, comparable transactions and future development costs primarily based on anticipated development capital programs.

In determining the future net cash flows, the Company utilized benchmark pricing forecasts from its reserve evaluator. The impairment assessment at December 31, 2017 was based the following forward commodity price estimates:

|            | Natural Gas                   | Crude Oil                         |                                       |
|------------|-------------------------------|-----------------------------------|---------------------------------------|
|            | AECO Gas Price<br>(Cdn\$/mcf) | Edmonton Par Price<br>(Cdn\$/bbl) | West Texas Intermediate<br>(US\$/bbl) |
| 2018       | 2.25                          | 70.10                             | 58.50                                 |
| 2019       | 2.65                          | 71.30                             | 58.70                                 |
| 2020       | 3.05                          | 74.90                             | 62.40                                 |
| 2021       | 3.40                          | 80.50                             | 69.00                                 |
| 2022       | 3.60                          | 82.80                             | 73.10                                 |
| 2023       | 3.65                          | 84.40                             | 74.50                                 |
| 2024       | 3.75                          | 86.10                             | 76.00                                 |
| 2025       | 3.80                          | 87.80                             | 77.50                                 |
| 2026       | 3.90                          | 89.60                             | 79.10                                 |
| 2027       | 3.95                          | 91.40                             | 80.70                                 |
| Thereafter | +2.0%/yr                      | +2.0%/yr                          | +2.0%/yr                              |

The Company recorded an impairment to exploration and evaluation assets of \$2.9 million (December 31, 2016 - \$nil) and property, plant and equipment of \$55.9 million for the year ended December 31, 2017 (December 31, 2016 – impairment reversal of \$58.5 million). The impairment recorded reflects the Company's best estimates based on currently available information.

| (\$000)            | December 31, 2017     |                       | December 31, 2016                   |                       |
|--------------------|-----------------------|-----------------------|-------------------------------------|-----------------------|
|                    | Impairment<br>Expense | Recoverable<br>Amount | Impairment<br>Expense<br>(reversal) | Recoverable<br>Amount |
| Steen/Marlow CGU   | \$ 55,900             | \$ 128,349            | \$ (58,479)                         | \$ 175,000            |
| Bistcho CGU        | -                     | -                     | 6,032                               | -                     |
| Other Canadian CGU | -                     | -                     | (286)                               | -                     |
| <b>Total</b>       | <b>\$ 55,900</b>      | <b>\$ 128,349</b>     | <b>\$ (52,733)</b>                  | <b>\$ 175,000</b>     |

A change in discount rate of 1.0% would have resulted in a change in impairment of \$8.5 million for the year ended December 31, 2017 (2016 – impairment reversal of \$9.3 million), while a ten percent decrease in the forward commodity price estimate, keeping exchange rates consistent, would affect the impairment by approximately \$40.9 million (2016 – impairment reversal of \$43.4 million).

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### 8. Convertible Debentures

The Company has \$106.1 million of senior secured convertible debentures (“Debentures”) outstanding. The Debentures mature on February 28, 2021 and bear an annual interest rate of 8.0%, payable semi-annually in arrears, with an option for the Company to pay the interest in an equivalent principal amount of debentures for the first two years. The Debentures are convertible into common shares at various conversion prices, subject to adjustment in certain events. The Debentures can be called prior to the maturity date by the Company if either a) the 90-day weighted average trading price of Strategic common shares is over four times the conversion price, or b) anytime in the fifth year of the term. The convertible debentures have been classified as a financial liability, net of issue costs and net of the equity component.

On February 28, 2017, \$3.7 million of debentures were issued as payment of interest in kind. Of the \$3.7 million, \$2.9 million were issued to entities controlled or jointly controlled by directors of the Company and an additional \$0.2 million were issued to directors and officers of the Company. The carrying amount of the financial liability of these convertible debentures was determined by discounting the stream of future payments of interest and principal, using a rate of 10.15% the estimated rate for debt with similar terms without conversion features.

On August 31, 2017, \$3.9 million of debentures were issued as payment of interest in kind. Of the \$3.9 million, \$3.0 million were issued to entities controlled or jointly controlled by directors of the Company and an additional \$0.2 million were issued to directors and officers of the Company. The carrying amount of the financial liability of these convertible debentures was determined by discounting the stream of future payments of interest and principal, using a rate of 10.40% the estimated rate for debt with similar terms without conversion features.

Below is a summary of the liability and equity components of the convertible debentures:

| (\$000)   |    | Liability<br>Component | Equity Component | Total             |
|---|----|------------------------|------------------|-------------------|
| Balance at December 31, 2016                                | \$ | 84,489                 | \$ 9,878         | \$ 94,367         |
| Additional debentures issued as payment in kind of interest |    | 7,077                  | 511              | 7,588             |
| Issuance costs  |    | (46)                   | (3)              | (49)              |
| Deferred tax recovery (Note 15)                             |    | -                      | (138)            | (138)             |
| Debentures converted  |    | (4)                    | (1)              | (5)               |
| Accretion on debentures                                     |    | 2,807                  | -                | 2,807             |
| Balance at December 31, 2017                                | \$ | <b>94,323</b>          | <b>\$ 10,247</b> | <b>\$ 104,570</b> |

The liability component of all debentures issued is being accreted to the adjusted amount of \$106.1 million at maturity. Below is a summary of the debentures issued and the related conversion prices:

| Issue Date        | Principal Amount (\$000) | Conversion Price (\$/share) |
|-------------------|--------------------------|-----------------------------|
| February 29, 2016 | 94,847                   | 1.80                        |
| August 31, 2016   | 3,617                    | 3.30                        |
| February 28, 2017 | 3,724                    | 2.70                        |
| August 31, 2017   | 3,864                    | 2.03                        |

Subsequent to year end, on February 28, 2018, \$4.1 million of debentures were issued as payment of interest in kind. Of the \$4.1 million additional debentures issued, \$3.1 million were issued to entities controlled by a director of the Company and an additional \$0.2 million were issued to directors and officers of the Company. The maturity date and the other terms of these debentures issued as payment of interest in kind are identical to the original convertible debentures other than the conversion price which is \$1.08 per share.

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### 9. Decommissioning liabilities

Total future decommissioning liabilities are estimated based on the Company's net working interest in all wells and facilities, the estimated costs to abandon and reclaim the wells and facilities and the estimated timing of the costs to be incurred in future periods. These costs are expected to be incurred over a range up to 34 years, depending on the estimated reserve life. The undiscounted amount of the estimated costs at December 31, 2017 were \$101.5 million (December 31, 2016 - \$97.6 million). The estimated costs have been discounted at a risk free rate from 1.66% to 2.20% (December 31, 2016 - 0.78% to 2.34%) and an inflation rate of 2% (December 31, 2016 - 2%) was applied.

The following table reconciles the changes to the Company's decommissioning liabilities:

| <b>(\$000)</b>                             | <b>December 31, 2017</b> | <b>December 31, 2016</b> |
|--|--------------------------|--------------------------|
| Balance beginning of the year              | \$ 52,651                | \$ 53,889                |
| Liabilities incurred during the year       | 925                      | 530                      |
| Disposition of liabilities                 | -                        | (25)                     |
| Expenditures on existing liabilities       | (2,333)                  | (1,625)                  |
| Revaluation on decommissioning liabilities | 7,190                    | -                        |
| Change in estimated future cash flows      | 170                      | 2,284                    |
| Change in discount rate                    | 2,598                    | (3,458)                  |
| Accretion                                  | 1,292                    | 1,056                    |
| Balance end of year                        | \$ 62,493                | \$ 52,651                |
| Current                                    | 3,190                    | 3,441                    |
| Long term                                  | \$ 59,303                | \$ 49,210                |

The change in estimated future cash flows includes an increase of \$1.5 million (December 31, 2016 - \$2.6 million) in the cost estimate of the decommissioning liability related to plant remediation at Steen River, expected to be expended by the end of 2048, and an increase of \$0.9 million related to the accelerated abandonment schedules for wells at Cameron Hills. The change in discount rate includes \$7.2 million related to CGUs that had previously been impaired to a recoverable value of \$nil and was recorded as a revaluation on decommissioning liabilities through the consolidated statements of net income (loss) and comprehensive income (loss).

### 10. Share capital

#### a) Authorized

The Company is authorized to issue an unlimited number of common shares without par value.

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## b) Issued and outstanding

Effective March 6, 2017 the Company's common shares were consolidated on the basis of one new share for twenty old shares (1:20) in the capital of the Company. All information regarding the issued and outstanding common shares, options and weighted average number and per share information has been retrospectively restated to reflect the twenty to one consolidation.

|  | # of Shares (000) | Amount (\$000) |
|--|-------------------|----------------|
| <b>Balance as at January 1, 2016</b>   | 27,116            | \$ 319,678     |
| Exercise of options                    | 5                 | 13             |
| Shares issued                          | 16,855            | 40,453         |
| Debentures converted                   | 2                 | 4              |
| Share issue costs                      | -                 | (75)           |
| <b>Balance as at December 31, 2016</b> | 43,978            | \$ 360,073     |
| Shares issued                          | 2,396             | 5,750          |
| Share issue costs                      | -                 | (411)          |
| Debentures converted                   | 3                 | 5              |
| Exercise of options                    | 14                | 49             |
| <b>Balance as at December 31, 2017</b> | 46,391            | \$ 365,466     |

On January 31, 2017, the Company issued a total of 2.4 million common shares via a brokered private placement offering (the "Private Placement") at a price of \$2.40 per common share for gross proceeds of \$5.7 million (net proceeds of \$5.3 million after transaction costs).

## c) Weighted average shares

| (000)                             | December 31, 2017 | December 31, 2016 |
|-----------------------------------|-------------------|-------------------|
| Weighted average shares (basic)   | <b>46,181</b>     | 27,533            |
| Weighted average shares (diluted) | <b>46,181</b>     | 71,700            |

For the year ended December 31, 2017, outstanding stock options and convertible debentures were excluded from the calculations as they were anti-dilutive.

## 11. Stock-based compensation

The Company has a stock option plan under which officers, directors, consultants and employees are eligible to receive stock options. The Company may reserve for issuance under the plan up to 10% of the issued and outstanding common shares. Options granted under the plan generally have a term of five years and vest at terms to be determined by the directors. Vesting terms have varied from immediate vesting to a three year vesting period and expire five years from the date of issue.

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The outstanding number and weighted average exercise price of stock options are as follows:

|                                     | Number of options | Weighted average<br>Exercise Price |
|-------------------------------------|-------------------|------------------------------------|
| <b>Balance at January 1, 2016</b>   | <b>568,250</b>    | \$ 15.20                           |
| Issued                              | 532,000           | 1.80                               |
| Exercised                           | (4,583)           | 1.80                               |
| Cancelled/Forfeited                 | (20,667)          | 7.20                               |
| Expired                             | (43,250)          | 21.60                              |
| <b>Balance at December 31, 2016</b> | <b>1,031,750</b>  | \$ 8.20                            |
| Issued                              | 1,523,000         | 2.65                               |
| Exercised                           | (14,434)          | 2.12                               |
| Cancelled/Forfeited                 | (29,500)          | 5.96                               |
| Expired                             | (202,000)         | 21.10                              |
| <b>Balance at December 31, 2017</b> | <b>2,308,816</b>  | \$ 3.50                            |

The following table sets out the outstanding and exercisable options as at December 31, 2017:

| Outstanding Options |  |   | Exercisable Options  |  |
|---------------------|--|---|----------------------|--|
| Number of Options   | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Life in<br>Years | Number of<br>Options | Weighted<br>Average<br>Exercise<br>Price |
| 2,007,066           | \$ 2.44                                  | 3.69                                    | 976,832              | \$ 2.34                                  |
| 257,250             | 8.39                                     | 1.67                                    | 257,250              | 8.39                                     |
| 2,750               | 9.71                                     | 1.32                                    | 2,750                | 9.71                                     |
| 500                 | 15.00                                    | 0.00                                    | 500                  | 15.00                                    |
| 500                 | 17.20                                    | 0.79                                    | 500                  | 17.20                                    |
| 1,500               | 19.13                                    | 0.80                                    | 1,500                | 19.13                                    |
| 500                 | 21.20                                    | 0.60                                    | 500                  | 21.20                                    |
| 20,000              | 22.74                                    | 0.39                                    | 20,000               | 22.74                                    |
| 18,750              | 25.92                                    | 0.10                                    | 18,750               | 25.92                                    |
| <b>2,308,816</b>    | <b>\$ 3.50</b>                           | <b>3.40</b>                             | <b>1,278,582</b>     | <b>\$ 4.27</b>                           |

The fair value of the options granted was estimated on the date of grant using a Black-Scholes option pricing model with the following weighted average inputs:

|   | December 31, 2017 | December 31, 2016 |
|---|-------------------|-------------------|
| Assumptions   |                   |                   |
| Risk free interest rate (%)                         | <b>1.01</b>       | 1.12              |
| Expected life (years)                               | <b>3.41</b>       | 3.54              |
| Expected volatility (%)                             | <b>100.29</b>     | 83.10             |
| Forfeiture rate (%)                                 | <b>7.48</b>       | 11.89             |
| Weighted average fair value of options granted (\$) | <b>1.74</b>       | 1.00              |

Forfeiture rate is calculated based on historical forfeiture data of the Company.

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## 12. Finance costs

| (\$000)   | Year ended December 31 |           |
|---|------------------------|-----------|
|   | 2017                   | 2016      |
| Interest expense  | \$ 56                  | \$ 806    |
| Interest expense on convertible debentures – paid in kind | 7,793                  | 6,120     |
| Interest expense on convertible debentures – cash portion | 435                    | 338       |
| Accretion of decommissioning liabilities                  | 1,292                  | 1,056     |
| Accretion on promissory notes                             | -                      | 19        |
| Accretion on convertible debentures                       | 2,807                  | 1,974     |
|   | \$ 12,383              | \$ 10,313 |

## 13. Income Taxes

The following table reconciles the expected income tax expense (recovery) at the Canadian federal and provincial statutory income tax rates to the amounts recognized in the consolidated statements of net income (loss) and comprehensive loss for the years ended December 31, 2017 and 2016.

| (\$000)                                     | 2017     | 2016     |
|---|----------|----------|
| Operating income (loss) before income taxes | (89,641) | 29,466   |
| Statutory income tax rates                  | 27.0%    | 27.0%    |
| Expected income tax (recovery) expense      | (24,203) | 7,956    |
| Non-deductible expenses                     | 5        | 4        |
| Change in unrecorded deferred tax benefits  | 23,519   | (11,873) |
| Stock-based compensation                    | 541      | 137      |
| Income tax recovery                         | (138)    | (3,776)  |

Details of deferred tax assets (liabilities) are as follows:

| (\$000)                           | December 31, 2017 | December 31, 2016 |
|-----------------------------------|-------------------|-------------------|
| Deferred tax assets (liabilities) |                   |                   |
| Non-capital loss carry forwards   | 3,165             | 3,773             |
| Convertible Debenture             | (3,165)           | (3,773)           |
| Deferred tax asset                | -                 | -                 |

Details of the unrecognized deductible temporary differences are as follows:

| (\$000)                                       | December 31, 2017 | December 31, 2016 |
|---|-------------------|-------------------|
| Non-capital loss carry forwards               | 302,811           | 269,281           |
| Share issuance cost and other                 | 2,046             | 2,985             |
| Oil and gas properties – US                   | 5,404             | 5,394             |
| Oil and gas properties – Canada               | 58,646            | 17,741            |
| Decommissioning liabilities                   | 62,466            | 52,656            |
| Unrecognized deductible temporary differences | 431,373           | 348,057           |

At this stage of the Company's development, it cannot be reasonably estimated that there will be future taxable profits, so no deferred tax assets have been recognized.

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At December 31, 2017, the Company has not recognized a deferred tax benefit in respect of its Canadian non-capital losses of approximately \$302.8 million (2016 - \$269.3 million) which may be carried forward to apply against future years' taxable income for Canadian tax purposes. Subject to final determination by taxation authorities, these losses expire as follows:

|      | (\$000)        |
|------|----------------|
| 2023 | 20,347         |
| 2024 | 27,717         |
| 2025 | 23,322         |
| 2026 | 4,585          |
| 2027 | 4,513          |
| 2028 | 5,841          |
| 2029 | 22,519         |
| 2030 | 1,442          |
| 2031 | 20,742         |
| 2032 | 35,398         |
| 2033 | 29,228         |
| 2034 | 11,769         |
| 2035 | 34,221         |
| 2036 | 24,817         |
| 2037 | 36,337         |
|      | <u>302,798</u> |

## 14. Supplemental cash flow information

| (\$000)   | December 31, 2017 | December 31, 2016 |
|---|-------------------|-------------------|
| Interest paid   | \$ 491            | \$ 1,144          |
| <b>Changes in non-cash working capital</b>                                  |                   |                   |
| Trade and other receivables   | \$ (431)          | \$ 5,637          |
| Inventory   | (51)              | 19                |
| Accumulated depletion in inventory  | 28                | (29)              |
| Accounts payable and accrued liabilities, net of accrued non-cash liability | (207)             | 861               |
| Withholding tax on debenture interest                                       | (2)               | -                 |
|   | <u>\$ (663)</u>   | <u>\$ 6,488</u>   |
| Operating   | (1,214)           | 5,179             |
| Financing   | (5)               | (26)              |
| Investing   | 556               | 1,335             |
|   | <u>\$ (663)</u>   | <u>\$ 6,488</u>   |

# Strategic Oil & Gas Ltd.

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## 15. Related parties

### a) Transactions with related parties

Legal fees in the amount of \$0.2 million (2016 - \$0.2 million) were incurred to a legal firm of which a director is a partner, and are included as general and administrative expenses or share issue costs. Software rental expense of \$0.2 million (2016 - \$0.2 million) were incurred to a software firm which is controlled by a former officer of the Company. Accounts payable and accrued liabilities at 2017 include \$nil (2016 - \$0.1 million) due to related parties.

The Company is in the process of entering into a joint arrangement with an entity controlled by a director of the Company to develop and explore an area of mutual interest in Northern Alberta. As at December 31, 2017, the related party has contributed lands to the joint arrangement and is committed to contributing additional capital of approximately \$9 million towards exploration costs for the area. Strategic intends to contribute undeveloped lands with a carrying value of \$0.5 million in exchange for a 10% carried interest in the development.

The above transactions were conducted in the normal course of operations and were recorded at exchange amounts which were agreed upon between the Company and the related parties. Transaction amounts reflect fair values.

### b) Transactions with key management personnel

The Company has determined that the key management personnel of the Company consist of its officers and directors. Short-term benefits are comprised of salaries and directors fees, annual bonuses, and other benefits. In addition, the Company provides share-based compensation to its key management personnel under the long-term incentive plans and the officers participate in the Company's share option plan. The compensation included in general and administrative expenses relating to key management personnel for the year is as follows:

| (\$000)                                       | 2017     | 2016     |
|---|----------|----------|
| Salaries, wages and other short-term benefits | \$ 1,116 | \$ 1,165 |
| Severance                                     | 840      | -        |
| Stock-based compensation                      | 1,081    | 364      |
| Total compensation                            | \$ 3,037 | \$ 1,529 |

## 16. Financial instruments and financial risk management

The Company's financial instruments include cash and cash equivalents, trade and other receivables, bank indebtedness, accounts payable and accrued liabilities, share-based payment transactions, convertible debentures and derivative financial instrument contracts. The carrying values of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, and bank indebtedness approximate their fair values due to their relatively short periods to maturity. The fair value of the convertible debenture liability approximates its carrying value.

The Company is required to classify fair value measurements using a hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy is as follows:

- Level 1 - quoted prices in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 - inputs for the asset or liability that are not based on observable market data.

The fair value of cash and cash equivalents is measured at level 1. The fair value of risk management contracts and conversion option component of promissory notes are measured at level 2.

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The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities. The Company has exposure to credit risk, liquidity risk and market risk as a result of its use of financial instruments. The following presents information about the Company's exposure to each of the above risks and the Company's objectives, policies and processes for measuring and managing commodity risks. Further quantitative disclosures are included throughout these consolidated financial statements.

## a) Market risk

Market risk consists of interest rate risk, currency risk and commodity price risk. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Company may use both financial derivatives and physical delivery sales contracts to manage market risks.

### Commodity price risk

Commodity price risk is the risk that the fair value of assets or liabilities or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic and geopolitical events that dictate the levels of supply and demand as well as the relationship between the Canadian and United States dollar. The Company may, in certain circumstances, enter into forward oil or natural gas sales contracts to mitigate commodity price risk.

There were no risk management contracts outstanding at December 31, 2017 and 2016.

### Interest rate risk

The Company is exposed to interest rate risk as changes in interest rates may affect future cash flows. The Company's cash balance and primary debt facility has a floating interest rate that will fluctuate based on prevailing market conditions. Cash flows are sensitive to changes in interest rates on this instrument. As at December 31, 2017, the Company did not hold any floating interest rate debt and therefore was not exposed to interest rate risk on its long-term debt.

### Foreign exchange risk

Prices for oil are determined in global markets and generally denominated in United States dollars. Natural gas and oil prices obtained by the Company are influenced by both US and Canadian demand and the corresponding North American supply, and recently, by imports of liquefied natural gas. The exchange rate effect cannot be quantified but generally an increase in the value of the \$CDN as compared to the \$US will reduce the prices received by the Company for its petroleum and natural gas sales. As at December 31, 2017 and 2016, the Company had no contracts in place to mitigate foreign exchange risk. As at December 31, 2017, the Company held \$0.1 million (December 31, 2016 - \$0.6 million) in \$US.

## b) Liquidity risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Company's reputation.

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Typically the Company ensures that it has sufficient cash on demand to meet expected operational expenses for a period of 30 days, including the servicing of financial obligations; this excludes the potential impact of extreme circumstances that cannot reasonably be predicted, such as natural disasters. To achieve this objective, the Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditure. The Company also attempts to match its payment cycle with collection of oil and natural gas revenue on the 25th of each month.

Due to continued net losses and capital expenditures exceeding cash flow from operating activities, the Company is exposed to increased liquidity risk. In order to fund future capital programs, the Company will need to obtain additional equity or debt financing, or assess other options. As at December 31, 2017 the Company had current asset of \$21.8 million and current liabilities of \$11.6 million.

### c) Credit risk

Credit risk is the risk that a customer or counterparty will fail to perform an obligation or fail to pay amounts due causing a financial loss. The Company's trade and other receivables are with customers in the oil and gas industry and are subject to normal credit risks. In 2017, 100% (2016 – 100%) of the Company's oil and natural gas production is being sold through marketing companies and revenues are collected on the 25th day of the month following the month of production. In order to mitigate collection risk, the Company assesses the credit worthiness of customers and counter parties by assessing the financial strength of the customers and by routinely monitoring credit risk exposures.

Collection of the remaining balances can be dependent upon industry factors such as commodity prices and risk of unsuccessful drilling. Otherwise, the Company does not typically obtain collateral from customers, and relies upon industry standard legal remedies for collection.

The Company's most significant customer, a Canadian oil and natural gas marketer, accounts for 84% of the trade receivables at December 31, 2017 (December 31, 2016: 72%) and 89% of 2017 revenues (December 31, 2016: 88%).

The total accounts receivable 90 days past due amounted to \$0.1 million at December 31, 2017 (2016 - \$0.1 million). The allowance for doubtful accounts at December 31, 2017 was \$0.1 million (2016 - \$nil).

### d) Offsetting financial assets and liabilities

The Company's risk management contracts are subject to master agreements that create a legally enforceable right to offset by counterparty the related financial assets and financial liabilities simultaneously. The Company had no outstanding risk management contracts at December 31, 2017 and 2016.

## 17. Capital management

Strategic considers its capital structure to include shareholders' equity and working capital including bank debt and convertible debentures. The objectives of the Company are to maintain a balance sheet that allows the Company financial flexibility to achieve goals of continued growth and access to capital. In order to maintain or adjust the capital structure, the Company may issue new common shares, issue new debt, or adjust exploration and development capital expenditures.

The Company monitors its spending programs based on available funds, which is working capital excluding risk management contracts and term deposits which are pledged as collateral for outstanding letters of credit. The Company will require external financing prior to incurring significant capital expenditures in future periods.

# Strategic Oil & Gas Ltd.

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## 18. Supplemental disclosure

Strategic's consolidated statements of net income (loss) and comprehensive income (loss) is prepared primarily by nature of expense, with the exception of employee compensation costs which are included in both operating and general and administrative expenses.

The following table details the amount of total employee compensation costs included in the operating and general and administrative expense line items in the consolidated statements of net income (loss) and comprehensive income (loss).

| <b>(\$000)</b>                           |    | <b>2017</b>  |    | <b>2016</b> |
|--|----|--------------|----|-------------|
| Operating                                | \$ | <b>1,865</b> | \$ | 1,709       |
| General and administrative               |    | <b>4,352</b> |    | 3,782       |
| <b>Total employee compensation costs</b> | \$ | <b>6,217</b> | \$ | 5,491       |

## 19. Commitments and contingencies

- a) The Company has lease agreements for office space, office equipment, vehicle leases and natural gas transportation resulting in the following commitments:

| <b>Year</b> | <b>Operating leases (\$000)</b> | <b>Gas transportation (\$000)</b> |
|-------------|---------------------------------|-----------------------------------|
| 2018        | \$ 452                          | \$ 454                            |
| 2019        | 409                             | 433                               |
| 2020        | 38                              | 414                               |
| 2021        | -                               | 367                               |
| 2022        | -                               | 342                               |
|             | \$ 899                          | \$ 2,010                          |

- b) By nature of its oil and gas operations in Northern Alberta, the Company is subject to numerous safety and environmental regulations, with which non-compliance may result in adverse financial impact. The Company mitigates these risks through the adherence to formal safety and environmental policies, as well as adequate insurance coverage. The Company is currently remediating an environmental spill at Marlowe. While the Company believes it has recorded its best estimate of the impact of this contingency in these financial statements, the ultimate outcome is uncertain.