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TEMAGAMI

Oil & Gas Ltd.

Annual Report
1986

EDWARD ROSS LIBRARY
OF MANAGEMENT

NOV 30 1987

McGILL UNIVERSITY

Officers and Directors

Donald C. Campbell
President, Chief Executive Officer and Director

R. Bruce Boyden
Director

John S. Grant, Jr.
Director

Carl R. Jonsson
Secretary and Director

Frederick G. Roman
Vice-President and Director

Irene Huntley
Vice-President and Controller

Transfer Agent and Registrar

Guaranty Trust Company of Canada
88 University Avenue
Toronto, Ontario
M5J 1T8

General Council

Tupper, Jonsson, Shroff & Zink
Vancouver, British Columbia

Auditors

Collins Barrow
Calgary, Alberta

Bankers

First Interstate Bank of California

Registered Office

1710, 1177 West Hastings Street
Vancouver, British Columbia
V6E 2L3

Corporate Office

2300, 300 - 5th Avenue S.W.
Calgary, Alberta
T2P 0L3

To Our Shareholders:

The most significant development for oil and gas companies during the last year has been the precipitous drop in crude oil prices. The very low prices we are currently experiencing, the uncertainties for future crude prices in both the short and medium terms, coupled with our high debt service requirements, have all severely limited your Company's activities.

Technically, operations on the Hiland leases in Wyoming, where your Company participates in eight producing wells, have been better than anticipated with production levels slightly higher than forecast and operating costs slightly below budget. Gas production, which is being sold to the nearby gas plant of Spectrum Energy, is up substantially over the year earlier. Prices, unfortunately, are down drastically.

The Company continues to hold interests in six wells in Texas and net revenue interests in a number of leases in Western Canada. A well is currently being drilled by a farmee on the Laird leases in the Northwest Territory in which your company holds an interest. The anticipated total depth of this well will be 3,400 meters, and is estimated to cost \$12.3 million. This well is being drilled at no cost to Temagami.

The major drop in crude prices has made it necessary for the Company to make a further provision for impairment in the value of the oil and gas properties. As a result of this write-down, our oil and gas properties are now carried on our books at a value of \$1.00.

During the year, the Wyoming State Auditor's office advised your company that Temagami had unpaid gas royalties and other compensation payable of U.S. \$1,562,679. We believe that these preliminary assessments are completely without merit and we are vigorously defending our rights in connection therewith. If the Minerals Management Service is successful in their claim, we would be obligated to pay royalties well in excess of the total revenue from the sale of such gas.

Significant improvements in oil and gas prices are essential for any realistic, favourable change in your company's fortunes.

On Behalf of the Board,


Donald C. Campbell,
President

October 31, 1986



Chartered Accountants

800 Gulf Canada Square
401-9th Avenue S.W.
Calgary, Canada T2P 3C5
(403) 298-1500
Telex: 03-821138

AUDITORS' REPORT

To the Shareholders
Temagami Oil & Gas Ltd.

We have examined the consolidated balance sheet of Temagami Oil & Gas Ltd. as at May 31, 1986 and the consolidated statements of loss and deficit and cash flow for the year then ended. Our examination was made in accordance with generally accepted auditing standards in Canada, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at May 31, 1986 and the results of its operations and cash flow for the year then ended in accordance with generally accepted accounting principles in Canada applied, except for the change in the method of accumulating exploration and development expenditures as explained in note 2(h) to the financial statements, on a basis consistent with that of the preceding year.

Collins Barrow

CHARTERED ACCOUNTANTS

Calgary, Canada
July 21, 1986

COMMENTS ON DIFFERENCE IN CANADA - UNITED STATES

REPORTING STANDARDS FOR AUDITORS

In the United States, reporting standards for auditors require the expression of an opinion qualified as being subject to the outcome of significant uncertainties affecting the financial statements such as the uncertainties referred to in the attached balance sheet as at May 31, 1986 and as described in notes 1, 6 and 8 to the financial statements. The opinion in our above report is expressed in accordance with Canadian standards and is not qualified with respect to, and provides no reference to, these uncertainties since such an opinion would not be in accordance with Canadian reporting standards for auditors when the uncertainties are adequately disclosed in the financial statements.

Collins Barrow

CHARTERED ACCOUNTANTS

Calgary, Canada
July 21, 1986

TEMAGAMI OIL & GAS LTD.

(Incorporated under the laws of British Columbia)

CONSOLIDATED BALANCE SHEET

MAY 31, 1986

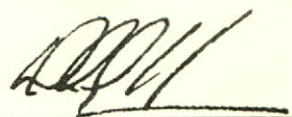
	<u>ASSETS</u>	<u>1986</u>	<u>1985</u>
Current assets			
Cash	\$	77,449	\$ 78,972
Accounts receivable		39,468	210,329
Current portion of agreement receivable		34,850	31,171
Marketable securities		<u>1,750</u>	<u>1,750</u>
		<u>153,517</u>	<u>322,222</u>
Agreement receivable (note 3)		<u>3,123</u>	<u>37,800</u>
Long-term account receivable (note 4)		<u>-</u>	<u>752,218</u>
Property and equipment (note 5)		<u>18,648</u>	<u>5,683,064</u>
	\$	<u>175,288</u>	\$ <u>6,795,304</u>

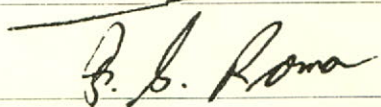
LIABILITIES

Current liabilities			
Accounts payable and accrued liabilities	\$	1,333,566	\$ 1,355,584
Current portion of long-term debt		<u>1,688,602</u>	<u>877,876</u>
		<u>3,022,168</u>	<u>2,233,460</u>
Long-term debt (note 6)		7,131,124	7,218,399
Less: Current portion		<u>(1,688,602)</u>	<u>(877,876)</u>
		<u>5,442,522</u>	<u>6,340,523</u>

SHAREHOLDERS' DEFICIENCY

Share capital (note 7)		6,880,000	6,880,000
Unrealized foreign exchange gain		1,670,357	1,621,753
Deficit		<u>(16,839,759)</u>	<u>(10,280,432)</u>
		<u>(8,289,402)</u>	<u>(1,778,679)</u>
Contingent liabilities (note 8)	\$	<u>175,288</u>	\$ <u>6,795,304</u>


_____, Director


_____, Director

TEMAGAMI OIL & GAS LTD.

CONSOLIDATED STATEMENT OF LOSS AND DEFICIT

YEAR ENDED MAY 31, 1986

	<u>1986</u>	<u>1985</u>
Revenue		
Oil and gas sales	\$ 1,233,630	\$ 1,561,263
Gas processing income	-	88,777
Interest and other	<u>5,922</u>	<u>79,914</u>
	<u>1,239,552</u>	<u>1,729,954</u>
Expenses		
Production and production taxes	379,726	530,178
Gas processing	-	126,687
General and administrative	151,668	255,183
Interest on long-term debt	714,444	906,493
Depletion	-	495,000
Depreciation	<u>4,510</u>	<u>143,547</u>
	<u>1,250,348</u>	<u>2,457,088</u>
Loss from operations	10,796	727,134
Loss on disposal of gas plant	-	818,400
Provision for impairment in value of oil and gas properties and equipment	6,548,531	8,380,000
Write-down of marketable securities to estimated net realizable value	<u>-</u>	<u>68,250</u>
Loss before income taxes	6,559,327	9,993,784
Deferred income tax recovery	<u>-</u>	<u>(357,272)</u>
Net loss	6,559,327	9,636,512
Deficit, beginning of year	<u>10,280,432</u>	<u>643,920</u>
Deficit, end of year	<u>\$ 16,839,759</u>	<u>\$ 10,280,432</u>
Loss per share	<u>\$ 0.626</u>	<u>\$ 0.920</u>

TEMAGAMI OIL & GAS LTD.

CONSOLIDATED STATEMENT OF CASH FLOW

YEAR ENDED MAY 31, 1986

	<u>1986</u>	<u>1985</u>
Operating activities		
Net oil and gas receipts	\$ 934,051	\$ 1,190,100
Interest and other receipts	5,922	44,113
General and administrative payments	(126,290)	(231,825)
Interest payments	(726,694)	(841,180)
	<u>86,989</u>	<u>161,208</u>
Investing activities		
Decrease (increase) in agreement receivable	31,247	(67,042)
Acquisition of property and equipment	-	(7,024)
Proceeds on disposal of property and equipment	-	449,909
Drilling credits received	-	31,527
	<u>31,247</u>	<u>407,370</u>
Financing activities		
Repayment of long-term debt	(120,101)	(537,044)
Cash inflow (outflow)	(1,865)	31,534
Cash, beginning of year	78,972	44,199
Foreign exchange gain on cash account	<u>342</u>	<u>3,239</u>
Cash, end of year	\$ <u>77,449</u>	\$ <u>78,972</u>

TEMAGAMI OIL & GAS LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MAY 31, 1986

1. Going concern

These financial statements have been prepared in accordance with generally accepted accounting principles. An assumption underlying the preparation of financial statements in accordance with generally accepted accounting principles is that the Company will be able to realize assets and discharge liabilities in the normal course of business for the foreseeable future rather than through a process of forced liquidation. At May 31, 1986, however, the Company had a shareholders' deficiency of \$8,289,402, a working capital deficiency of \$2,868,651 and did not generate enough cash flow to meet the minimum requirement of its debt obligation. The ability of the company to continue operating as a going concern is dependent on the continued management support of the related party referred to in note 10, the financial support of its banker and the ability to generate sufficient cash flow from its current operations to discharge its liabilities and meet its obligations under the terms of the bank loan agreement as described in note 6.

2. Significant accounting policies

The consolidated financial statements of the company have been prepared by management in accordance with accounting principles generally accepted in Canada, which, in the case of the company, conform in all material respects with International Accounting Standards. These financial statements have in management's opinion been properly prepared within reasonable limits of materiality and in light of information available up to July 21, 1986. The principal accounting policies are summarized as follows:

(a) Principles of consolidation

The consolidated financial statements include, in addition to the accounts of the company, the accounts of its wholly-owned subsidiary, Temagami Oil & Gas Inc.

(b) Exploration and development costs

The company follows the full cost method of accounting for exploration and development expenditures, whereby all costs related to the exploration for and the development of oil and gas reserves are initially capitalized and accumulated in country-by-country cost centres (Canada and the United States). Costs capitalized include land acquisition costs, geological and geophysical expenditures, rentals on undeveloped properties, costs of drilling productive and non-productive wells together with overhead and interest directly related to exploration and development activities. Proceeds on minor property sales are credited to the net book value of the property and equipment. Gains or losses on major property sales are normally recognized in the statement of loss.

TEMAGAMI OIL & GAS LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MAY 31, 1986

2. Significant accounting policies (cont'd)

Costs capitalized in each of the cost centres are depleted on the composite unit-of-production method based on estimated proven oil and gas reserves as determined by independent and company engineers.

In applying the full cost method, the Company calculates a ceiling test which restricts the capitalized costs less accumulated depletion and depreciation for each cost centre from exceeding an amount equal to the estimated undiscounted value of future net revenues from proven oil and gas reserves, based on current prices and costs, and after deducting estimated future general and administrative expenses, financing costs and income taxes for each cost centre. In calculating the above cost centre ceiling tests, gas was converted to oil on a 6 MCF to 1 BBL equivalent basis and \$12 U.S. per barrel of oil was used as the current price of oil.

(c) Depreciation

Depreciation of production equipment is provided for on the composite unit-of-production method. Depreciation of other equipment is computed on the declining balance method at rates varying from 20 to 30 percent per annum.

(d) Joint venture

Substantially all of the exploration and production activities of the company are conducted jointly with others and accordingly these financial statements reflect only the company's proportionate interest in such activities.

(e) Translation of foreign currencies

The U.S. operations are considered financially and operationally independent of the parent company and have been translated into Canadian dollars as follows: assets and liabilities at the rate of exchange at the balance sheet date, revenues and expenses at the average rate of exchange during the year. Gains or losses on translation are shown as a separate component in shareholders' equity.

(f) Marketable securities

Marketable securities are carried at the lower of cost or estimated net realizable value.

(g) Loss per share

Net loss per share is based on the weighted average number of common shares outstanding during the year.

TEMAGAMI OIL & GAS LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MAY 31, 1986

2. Significant accounting policies (cont'd)

(h) Change in accounting policy

The Company prospectively adopted two cost centres, Canada and the United States, in respect of costs capitalized under the full cost method of accounting for petroleum and natural gas properties. Previously the Company utilized one cost centre, that being North America. The change in policy was made to conform with the Full Cost Accounting Guideline as proposed by the Canadian Institute of Chartered Accountants.

3. Agreement receivable

The agreement receivable bears interest at 10 3/4% and is due in monthly installments of \$3,104 including interest.

	<u>1986</u>	<u>1985</u>
Balance, end of year	\$ 37,973	\$ 68,971
Less: Current portion	<u>34,850</u>	<u>31,171</u>
	<u>\$ 3,123</u>	<u>\$ 37,800</u>

4. Long-term account receivable

The long-term account receivable is due from joint venture participant and relates to certain joint venture agreements which the company has entered into to develop oil and gas properties. The propriety and status of these joint venture agreements is uncertain, and in dispute. Management is of the opinion that any adjustments which may result upon resolution of the dispute can not be reasonably estimated at this time and an allowance for non-collection has been made with the amount included in property and equipment.

	<u>1986</u>	<u>1985</u>
Balance, beginning of year	\$ 755,669	\$ 752,218
Allowance	<u>(755,669)</u>	<u>-</u>
Balance, end of year	<u>\$ -</u>	<u>\$ 752,218</u>

TEMAGAMI OIL & GAS LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MAY 31, 1986

5. Property and equipment

Property and equipment consists of the following:

	<u>1986</u>			<u>1985</u>
	<u>Cost</u>	<u>Accumulated Depletion and Depreciation</u>	<u>Net</u>	<u>Net</u>
Oil and gas properties including exploration and development costs thereon	\$ 4,864,600	\$ 4,864,599	\$ 1	\$ 5,393,114
Production equipment	470,075	470,075	-	266,794
Other equipment	<u>153,947</u>	<u>135,300</u>	<u>18,647</u>	<u>23,156</u>
	<u>\$ 5,488,622</u>	<u>\$ 5,469,974</u>	<u>\$ 18,648</u>	<u>\$ 5,683,064</u>

6. Long-term debt

Long-term debt consists of the following:

	<u>1986</u>	<u>1985</u>
Bank loan (1986 - U.S. \$5,165,000; 1985 - U.S. \$5,250,000)	\$ 7,125,634	\$ 7,209,825
Obligations under capital leases	<u>5,490</u>	<u>8,574</u>
	<u>\$ 7,131,124</u>	<u>\$ 7,218,399</u>

- (a) The bank loan is secured by all assets of the company. The loan currently bears interest at a U.S. bank's prime rate plus 1/2% and is repayable in U.S. dollars.

The company may at any time elect to alter the interest terms as follows:

To December 31, 1986 at 1/2% in excess of Cost of Funds, as defined by loan agreement, for amounts not exceeding \$2,000,000 U.S. and at a U.S. bank's prime rate plus 1/2% on the balance; and

From January 1, 1987, until principal and interest are paid in full, at a U.S. bank's prime rate plus 1/2%.

TEMAGAMI OIL & GAS LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MAY 31, 1986

6. Long-term debt (cont'd)

The bank loan agreement requires that the company dedicate 95% to 100% of its "net cash flow" (as defined in the loan agreement) towards principal payments each month. If the total principal payment from "net cash flow" is less than \$165,000 in any calendar quarter in 1986 then a supplementary payment is required on the last day of such calendar quarter to bring the total principal payment up to the required minimum payment. The company has been dedicating 95% to 100% of its "net cash flow" towards principal payments but such payments have been inadequate to meet the required minimum calendar quarter payment. Subsequent to year-end, the cash flow has also been insufficient to meet required monthly interest payments. The bank has however not demanded further payment in satisfaction of the deficiency in interest or principal. The deficiency at May 31, 1986 has been included in the current portion of the long-term debt.

Estimated minimum repayments (U.S. \$) required under the loan agreement in the next five years are as follows:

1987	\$ 1,220,000
1988	660,000
1989	660,000
1990	660,000
1991	660,000
Subsequent years	<u>1,305,000</u>
	<u>\$ 5,165,000</u>

- (b) Total minimum lease payments of \$5,490 are due in the current year and are secured by other equipment.

7. Share capital

Authorized and issued share capital consist of the following:

	<u>1986</u>	<u>1985</u>
Authorized		
100,000 Preferred Shares Series A with a par value of \$1 each		
100,000 Preferred Shares Series B with a par value of \$1 each		
100,000 Preferred Shares Series C with a par value of \$1 each		
15,000,000 Common Shares without par value		
Issued		
10,470,000 Common Shares	<u>\$ 6,880,000</u>	<u>\$ 6,880,000</u>

TEMAGAMI OIL & GAS LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MAY 31, 1986

8. Contingent liabilities

- (a) During the year, the company's Wyoming leases were investigated by the Wyoming State Auditor's Office, on behalf of the Minerals Management Service of the United States Department of the Interior, for the period from August 1980 through December, 1985. Preliminary findings were that Temagami underpaid gas royalties and compensation by U.S. \$1,562,679, as follows:

Natural gas royalty	U.S. \$	99,727
Flared gas compensation		1,460,671
Ad valorem tax reimbursement		<u>2,281</u>
	U.S. \$	<u>1,562,679</u>

Temagami has presented documentation to the Wyoming State Auditor to refute the preliminary findings concerning the flared gas compensation.

Subsequent to Temagami's fiscal year end, the Minerals Management Service issued a formal demand for deemed unpaid royalties in the amount of U.S. \$94,471. This demand corresponds to the preliminary findings of the Wyoming State Auditor for "Natural gas royalty". Temagami has formally appealed this assessment.

The preliminary assessment of the Wyoming State Auditor's office and the Minerals Management Service relate to the total working interest value of the leases operated by Temagami. In the event the assessment becomes payable, Temagami would have a claim against its joint venture participants for approximately 50% of the assessment.

In the opinion of management, this assessment is without merit and Temagami is vigorously defending its rights in connection herewith. Any assessment which may become payable as a result of the above action will be retroactively adjusted to income for the period in question.

- (b) Included in accounts payable is a liability relating to 1982 capital expenditures on which monthly invoices have been received for interest owing on the unpaid balance. As at May 31, 1986, the accumulated interest of \$116,870 has not been accrued as management feels the likelihood of eventual payment of the interest is not determinable.

9. Remuneration of directors and officers

The total remuneration paid to directors and officers of the company amounted to \$48,000 (1985 - \$48,000).

TEMAGAMI OIL & GAS LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

MAY 31, 1986

10. Related party transactions

Included in accounts payable is \$464,248 (1985 - \$432,791) interest payable to a related party which owns a significant interest in the company. The amount represents debenture interest accrued to November 15, 1981 (the date on which the debenture was converted to common shares) plus interest charged on the unpaid debenture interest at the rate of 1% over a Canadian bank's prime rate.

During the year no payments on account were made. No fixed repayment terms have been determined.

Included in accounts payable is \$428,340 (1985 - \$426,380) of joint venture billings due to an affiliated company.

11. Loss carryforwards

As at May 31, 1986, the company has non-capital losses for income tax purposes available to be carried forward and applied against taxable income of future years as follows:

	<u>Year Incurred</u>	<u>Approximate Amount</u>	<u>Year of Expiry</u>
<u>Canadian Operations</u>	1983	\$ 136,699	1988
	1984	138,196	1991
	1985	12,428	1992
	1986	<u>15,000</u>	1993
		<u>\$ 302,323</u>	
<u>U.S. Operations</u>	1979	\$ 838,471 (U.S.)	1994
	1980	2,272,501 (U.S.)	1995
	1981	666,331 (U.S.)	1996
	1982	2,017,659 (U.S.)	1997
	1983	1,320,545 (U.S.)	1998
	1984	674,629 (U.S.)	1999
	1985	360,673 (U.S.)	2000
	1986	<u>101,939 (U.S.)</u>	2001
		<u>\$ 8,252,748</u>	