Zargon Oil & Gas Ltd.

2011 Q1 FINANCIAL REPORT

Focused on exploitation

FINANCIAL & OPERATING HIGHLIGHTS

	Three Months Ended March 31,		
(unaudited)	**2011**	2010 (restated)	Percent Change
Financial			
Income and Investments ($ millions)			
Petroleum and natural gas sales, before royalties	**46.94**	48.46	(3)
Funds flow from operating activities	**15.22**	21.98	(31)
Cash flows from operating activities	**23.47**	20.74	13
Cash dividends (net of Dividend Reinvestment Plan)	**9.65**	12.55	(23)
Net earnings/(losses)	**(9.11)**	4.35	(309)
Net capital expenditures	**20.36**	18.24	12
Per Share, Diluted			
Funds flow from operating activities ($/share)	**0.56**	0.84	(33)
Cash flows from operating activities ($/share)	**0.86**	0.79	9
Net earnings/(losses) ($/share)	**(0.33)**	0.17	(294)
Cash Dividends ($/common share)	**0.42**	0.54	(22)
Balance Sheet at Period End ($ millions)			
Property and equipment (D&P)	**418.88**	406.27	3
Exploration and evaluation assets (E&E)	**27.56**	25.04	10
Bank debt	**121.89**	84.23	45
Shareholders' equity	**191.92**	177.21	8
Total Common Shares Outstanding at Period End (millions)	**27.28**	26.20	4
Operating			
Average Daily Production			
Oil and liquids (bbl/d)	**5,893**	5,554	6
Natural gas (mmcf/d)	**21.92**	27.05	(19)
Equivalent (boe/d)	**9,546**	10,062	(5)
Equivalent per million common shares (boe/d)	**349**	385	(9)
Average Selling Price (before the impact of financial risk management contracts)			
Oil and liquids ($/bbl)	**75.29**	73.63	2
Natural gas ($/mcf)	**3.55**	4.79	(26)
Wells Drilled, Net	**7.5**	12.8	(41)
Undeveloped Land at Period End (thousand net acres)	**498**	516	(3)

Notes:

For the convenience of the reader, the comparative information presented in this schedule refers to common shares and cash dividends although, for the pre-corporate conversion period, these items were trust units and cash distributions.

Throughout this report, the calculation of barrels of oil equivalent ("boe") is based on the conversion ratio that six thousand cubic feet of natural gas is equivalent to one barrel of oil. For a further discussion about this term, refer to the Management's Discussion and Analysis section in this report.

For net capital expenditures, amounts include capital expenditures acquired for cash, equity issuances and net debt assumed on corporate acquisitions.

Funds flow from operating activities is a non-GAAP term that represents net earnings/losses and asset retirement expenditures except for non-cash items. For a further discussion about this term, refer to the Management's Discussion and Analysis section in this report.

Total shares outstanding, for 2010, include trust units plus exchangeable shares outstanding at period end. The exchangeable shares were converted at the exchange ratio at the end of the period.

Average daily production per million common shares, for 2010, is calculated using the weighted average number of units outstanding during the period plus the weighted average number of exchangeable shares outstanding for the period converted at the average exchange ratio for the period.

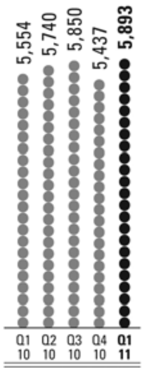
FINANCIAL & OPERATING HIGHLIGHTS

Zargon Oil & Gas Ltd. ("Zargon" or the "Company") is pleased to report its financial results for the first quarter of 2011.

Highlights from the three months ended March 31, 2011 are noted below:

- First quarter 2011 production averaged 9,546 barrels of oil equivalent per day, two percent higher than the preceding quarter and five percent lower than the corresponding 2010 quarter. Reflecting Zargon's continuing focus on oil exploitation, oil and liquids production increased eight percent over the previous quarter to average 5,893 barrels per day, a six percent increase over the corresponding 2010 quarter.
- Funds flow from operating activities of $15.22 million ($0.56 per diluted share) were six percent higher than the $14.40 million ($0.55 per diluted share) recorded in the fourth quarter of 2010, and 31 percent lower than the $21.98 million ($0.84 per diluted share) reported in first quarter 2010. The first quarter 2011 amount was reduced by an allowance of $1.27 million for prior period tax contingencies, $3.01 million for realized hedge losses, $0.21 million for the cash portion of exploration and evaluation expenses and $0.66 million of asset retirement expenditures.
- Three monthly cash dividends of $0.14 per common share were declared in the first quarter of 2011 for a total of $11.40 million ($9.65 million after accounting for the common shares issued for the Dividend Reinvestment Plan ("DRIP")). These cash dividends (net of the DRIP) were equivalent to a payout ratio of 63 percent of funds flow from operating activities.
- Exploration and development capital expenditures (excluding property acquisitions and dispositions) increased 29 percent from the prior quarter to $22.25 million primarily due to an active winter drilling program.
- Debt net of working capital (excluding unrealized derivative assets/liabilities) increased nine percent from the prior quarter to $135.13 million at March 31, 2011.
- Subsequent to quarter end, Zargon closed an offering of 1.725 million common shares on a bought deal basis at $22.60 per share for total gross proceeds of $38.99 million ($36.93 million net of issue costs). The proceeds will be used to pay down debt and to partially fund the 2011 capital program.

OIL AND LIQUIDS PRODUCTION (bbl/d)



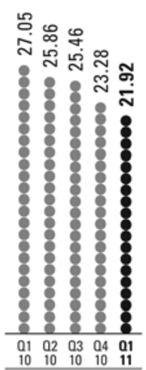
Production [1]

Oil and liquids production averaged 5,893 barrels per day, an eight percent increase from the 5,437 barrels per day produced in the 2010 fourth quarter, and was supported by an active winter oil exploitation horizontal drilling program in the Williston Basin and Alberta Plains South core areas. Oil and liquids production represented 62 percent of total production based on a 6:1 equivalent basis, up from 55 percent in the 2010 first quarter and 49 percent in the 2009 first quarter. Further oil production increases are anticipated in 2011 as Zargon is continuing to direct virtually all capital spending to oil exploitation projects, which have stronger returns available than our natural gas projects. Measured on a per million share basis, the 2011 first quarter oil and liquids production averaged 216 barrels per day, a seven percent increase from the daily average of 202 barrels per day in the fourth quarter of 2010 and a one percent increase from 213 barrels per day in the first quarter of 2010.

Natural gas production averaged 21.92 million cubic feet per day, a six percent decrease from the previous quarter and a 19 percent decrease from the corresponding period in 2010. The declining trend in natural gas production reflects the strategic shift to oil exploitation and the resulting naturally occurring production declines.

Capital Expenditures and Budgets [1]

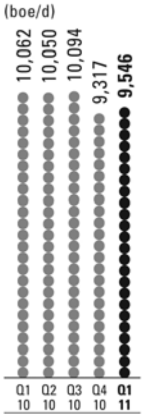
NATURAL GAS PRODUCTION (mmcf/d)



Reflecting an active winter 2010-11 horizontal drilling, completion and tie-in program, Zargon's first quarter field capital program totalled $22.25 million, a 29 and 53 percent increase from the respective 2010 fourth quarter and 2010 first quarter. During the quarter, Zargon drilled eight gross wells that resulted in 7.5 net oil wells for a 100 percent success ratio. The drilling program included four oil exploitation horizontal wells (Steelman, Elswick and Manor) in the Williston Basin core area, three Taber horizontal wells in the Alberta Plains South core area and one Hamilton Lake horizontal well in the Alberta Plains North core area. Zargon also completed property dispositions totalling a net $1.94 million.

The 2011 capital program has been increased by $10 million to total $65 million following Zargon's recent equity issuance. Zargon will conduct a program of continuous oil exploitation drilling in each of its core areas. Following spring breakup, a horizontal drilling rig in the Williston Basin is scheduled to drill three Elswick locations, then four wells at Weyburn before returning to Steelman later in the year. In Alberta, a second rig is scheduled to drill four Glauconite oil exploitation wells at Killam and three horizontal oil exploitation wells in Taber. The rig will then move to Hamilton Lake to follow up on our potentially significant Viking reservoir optimization project where one multi-frac horizontal well has been drilled and long term production testing will begin once surface access is available. Two additional horizontal drainage wells are planned at the Hamilton Lake property prior to year end. Also in Alberta, following spring break-up, a total of seven vertical oil exploitation step-out wells will be drilled in the Bellshill Lake and Grand Forks properties.

PRODUCTION (boe/d)



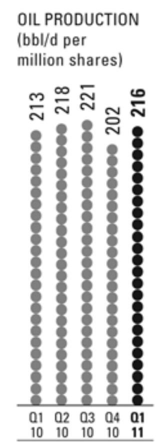
At Zargon's Little Bow Alkaline Surfactant Polymer ("ASP") tertiary recovery project, we anticipate project sanctioning later this summer, which should lead to preliminary fourth quarter 2011 expenditures and allow for a fall 2012 implementation date.

Guidance [1]

On March 10, 2011, Zargon provided a 2011 quarterly oil production guidance range of 5,600 to 6,100 barrels of oil per day for 2011. Consistent with this guidance, Zargon's first quarter 2011 production averaged 5,893 barrels of oil per day. In the second quarter, we have experienced severe flooding and related surface access problems with many of our Williston Basin producers due to heavy winter snows and a wet spring that has shut-in up to 1,000 barrels per day for more than six weeks. Consequently, we do not expect to meet the oil production guidance range in the second quarter, but, with the expected resolution of our surface access challenges and the June resumption of an active summer-fall oil exploitation horizontal drilling program, we anticipate that third and fourth quarter oil production volumes will return to the 5,600 to 6,100 barrels of oil per day guidance range.

With essentially no capital allocated to natural gas projects, our natural gas production can be expected to continue to decline from the first quarter rate of 21.92 million cubic feet per day, although we anticipate that our previously announced guidance range of 20.4 to 22.8 million cubic feet per day will be met in each of the next three quarters.

(1) Please see comments on "Forward-Looking Statements" in the Management's Discussion and Analysis section in this report.



MANAGEMENT'S DISCUSSION AND ANALYSIS

Management's discussion and analysis ("MD&A") is a review of Zargon Oil & Gas Ltd.'s 2011 first quarter financial results and should be read in conjunction with the unaudited interim consolidated financial statements and related notes for the three months ended March 31, 2011 and the audited consolidated financial statements and related notes for the year ended December 31, 2010. The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS"), which are also generally accepted accounting principles ("GAAP") for publicly accountable enterprises in Canada. All amounts are in Canadian dollars unless otherwise noted. All references to "Zargon" or the "Company" refer to Zargon Oil & Gas Ltd.

In the MD&A, reserves and production are commonly stated in barrels of oil equivalent ("boe") on the basis that six thousand cubic feet of natural gas is equivalent to one barrel of oil. Boes may be misleading, particularly if used in isolation. A boe conversion ratio of six thousand cubic feet of natural gas to one barrel of oil is based on an energy equivalent conversion method primarily applicable to the burner tip and does not represent a value equivalent at the wellhead.

The following are descriptions of non-GAAP measures used in this MD&A:

- *The MD&A contains the term "funds flow from operating activities" ("funds flow"), which should not be considered an alternative to, or more meaningful than, "cash flows from operating activities" as determined in accordance with IFRS as an indicator of the Company's financial performance. This term does not have any standardized meaning as prescribed by IFRS and, therefore, the Company's determination of funds flow from operating activities may not be comparable to that reported by other companies. The reconciliation between cash flows from operating activities and funds flow from operating activities can be found in the table below and in the consolidated statements of cash flows in the consolidated financial statements. The Company evaluates its performance based on net earnings and funds flow from operating activities. The Company considers funds flow from operating activities to be a key measure as it demonstrates the Company's ability to generate the cash necessary to pay dividends, repay debt and to fund future capital investment. It is also used by research analysts to value and compare oil and gas companies, and it is frequently included in published research when providing investment recommendations. Funds flow from operating activities per share is calculated using the diluted weighted average number of shares for the period.*

Funds Flow from Operating Activities Reconciliation

	Three Months Ended March 31,	
($ millions)	**2011**	2010
Cash flows from operating activities	**23.47**	20.74
Changes in non-cash operating working capital	**(8.25)**	1.24
Funds flow from operating activities	**15.22**	21.98

- *The Company also uses the term "debt net of working capital" or "net debt". Debt net of working capital, as presented, does not have any standardized meaning prescribed by IFRS and may not be comparable with the calculation of similar measures for other entities. Debt net of working capital, as used by the Company, is calculated as bank debt and any working capital deficit excluding unrealized derivative assets/liabilities and fair value of exchangeable shares.*

- *Operating netbacks per boe equal total petroleum and natural gas sales per boe adjusted for realized derivative gains and/or losses per boe, royalties per boe, production costs per boe and transportation costs per boe. Operating netbacks are a useful measure to compare the Company's operations with those of its peers.*

- *Funds flow netbacks per boe are calculated as operating netbacks less general and administrative expenses per boe, transaction costs per boe, interest and financing charges per boe, asset retirement expenditures per boe, exploration and evaluation and other expense per boe and current income taxes per boe. Funds flow netbacks are a useful measure to compare the Company's operations with those of its peers.*

References to "production volumes" or "production" in this document refer to sales volumes.

As a result of the Company's conversion from an income trust to a corporation on December 31, 2010, all references herein to common shares, shareholders, share rights and dividends relate to trust units, unitholders, trust unit rights and distributions for periods prior to December 31, 2010.

Forward-Looking Statements – This document offers our assessment of Zargon's future plans and operations as at May 12, 2011, and contains forward-looking statements including:

- *our expectations for production referred to under the heading "Financial & Operating Highlights";*
- *our expectations for capital expenditures referred to under the heading "Financial & Operating Highlights";*
- *our expectations implementing International Financial Reporting Standards referred to under the heading "Transition to International Financial Reporting Standards";*
- *our expectations for proceeds received from the bought deal financing referred to under the headings "Financial & Operating Highlights", "Summary of Significant Events in the First Quarter" and "Subsequent Event";*
- *our expectations for royalties referred to under the heading "Financial Analysis";*
- *our expectations for production costs and transportation costs referred to under the heading "Financial Analysis";*
- *our expected sources of funds for dividends and capital expenditures referred to under the heading "Liquidity and Capital Resources";*
- *our dividend policy referred to under the heading "Liquidity and Capital Resources"; and*
- *our expectations for operating results referred to under the headings "Financial & Operating Highlights" and "Outlook".*

Such statements are generally identified by the use of words such as "anticipate", "continue", "estimate", "expect", "forecast", "may", "will", "project", "should", "plan", "intend", "believe" and similar expressions (including the negatives thereof). By their nature, forward-looking statements are subject to numerous risks and uncertainties, some of which are beyond our control, including such as those relating to results of operations and financial condition, general economic conditions, industry conditions, changes in regulatory and taxation regimes, volatility of commodity prices, escalation of operating and capital costs, currency fluctuations, the availability of services, imprecision of reserve estimates, geological, technical, drilling and processing problems, environmental risks, weather, the lack of availability of qualified personnel or management, stock market volatility, the ability to access sufficient capital from internal and external sources and competition from other industry participants for, among other things, capital, services, acquisitions of reserves, undeveloped lands and skilled personnel. Risks are described in more detail in our Annual Information Form, which is available on our website and at www.sedar.com. Forward-looking statements are provided to allow investors to have a greater understanding of our business.

You are cautioned that the assumptions, including among other things, future oil and natural gas prices; future capital expenditure levels; future production levels; future exchange rates; the cost of developing and expanding our assets; our ability to obtain equipment in a timely manner to carry out development activities; our ability to market our oil and natural gas successfully to current and new customers; the impact of increasing competition, our ability to obtain financing on acceptable terms; and our ability to add production and reserves through our development and acquisition activities used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be imprecise and, as such, undue reliance should not be placed on forward-looking statements. Our actual results, performance, or achievements could differ materially from those expressed in, or implied by, these forward-looking statements. We can give no assurance that any of the events anticipated will transpire or occur, or if any of them do, what benefits we will derive from them. The forward-looking information contained in this document is expressly qualified by this cautionary statement. Our policy for updating forward-looking statements is that Zargon disclaims, except as required by law, any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

This MD&A has been prepared as of May 12, 2011.

TRANSITION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

The financial information presented herein has been prepared on the basis of International Financial Reporting Standards ("IFRS") for the interim consolidated financial statements and is expressed in Canadian dollars unless otherwise stated.

The amounts in this MD&A and the interim consolidated financial statements for the three months ended March 31, 2010 have been restated to reflect our adoption of IFRS, with effect from January 1, 2010. Periods prior to January 1, 2010 have not been restated and are prepared in accordance with accounting standards which were in effect in Canada prior to conversion to IFRS ("Canadian GAAP"). Please refer to Note 25 of our March 31, 2011 interim unaudited consolidated financial statements for a summary of the differences between our financial statements previously prepared under Canadian GAAP and to those under IFRS for the three months ended March 31, 2010 and for the year ended December 31, 2010.

The March 31, 2011 interim unaudited consolidated financial statements and this MD&A have been prepared using the standards and interpretations currently issued and expected to be effective at the end of our first annual IFRS reporting period, which will be December 31, 2011. Subsequent changes to IFRS may be given effect in the Company's December 31, 2011 annual consolidated financial statements and could result in a restatement of the March 31, 2011 interim statements and the January 1, 2010 underlying values prepared on a basis consistent with IFRS.

The key areas of adjustment to the January 1, 2010 and December 31, 2010 balance sheets as a result of the transition to IFRS were as follows:

- Impairment of Property Plant and Equipment ("PP&E") under IFRS was tested as required on initial transition to IFRS based on discounted cash flows for each Cash Generating Unit ("CGU"), which is a more granular level than what was required under Canadian GAAP. Also, under Canadian GAAP, a discounted cash flow analysis was not required if the undiscounted cash flows from proved reserves exceeded the carrying amount. At January 1, 2010, no impairment was identified. Impairment of PP&E must also be assessed whenever there is an indication of impairment such as changes in commodity prices or operational performance. Based on the reduction in natural gas prices in the fourth quarter of 2010, an impairment test was undertaken which resulted in recording impairment losses to PP&E totalling $22.87 million for four CGU's at December 31, 2010.
- The provision for asset retirement obligations was re-measured at January 1, 2010 and each subsequent reporting period using the risk-free discount rate in effect at that time. Under Canadian GAAP, a credit-adjusted rate was used and, once recorded, asset retirement obligations were not adjusted for future changes in discount rates.
- Exploration and Evaluation ("E&E") expenditures were reclassified from PP&E and included as "Exploration and evaluation assets" on the consolidated balance sheets and consist of undeveloped land. The E&E assets will not be depleted and were evaluated each reporting period to determine whether they should be reclassified to PP&E as developed and producing assets. E&E assets must be assessed for impairment when indicators of impairment exist. No impairments were recorded.
- The Company's exchangeable shares were reclassified to current liabilities and re-measured to fair value at January 1, 2010 and at each reporting period. The resulting gains or losses were reported in the statement of earnings. Under Canadian GAAP, the exchangeable shares were reported as a non-controlling interest. All outstanding exchangeable shares were converted to common shares in conjunction with the December 31, 2010 corporate conversion.
- The Zargon Energy Trust portion of the deferred tax liability was re-measured on transition at January 1, 2010 using the top personal marginal tax rate as required by IFRS due to the trust structure that existed at the time. Upon the Company's conversion to a corporate structure at December 31, 2010, the deferred tax liability was re-measured using the applicable federal corporate income tax rate, which was the rate that had been used under Canadian GAAP for both trust and corporate structures.

- For the reporting periods in which the Company was structured as an income trust, the unit-based compensation was considered under IFRS to be cash-settled and was therefore classified as a liability on the balance sheet and re-measured at fair value at each reporting period. Upon conversion to a corporation, the unit-based compensation liability was reclassified to contributed surplus.
- The functional currency for the Company's US subsidiaries was determined to be US dollars, while the presentation currency for the consolidated entity is Canadian dollars. As a result, under IFRS, all items on the US consolidated balance sheet with the exception of equity must be converted using the foreign exchange rate in effect at the end of each reporting period. The initial adjustment was recorded against retained earnings and adjustments for each subsequent reporting period are recorded to the currency translation adjustment in equity and other comprehensive income.

The additional impacts of the IFRS transition on the Company's statement of earnings are as follows:

- Petroleum and natural gas revenues are now reported net of royalties, which were previously shown separately in expenses under Canadian GAAP.
- Depreciation and depletion costs have decreased due to an IFRS-permitted depletion policy utilizing proved and probable reserves as the depletion base. Previously, the Company's depletion was calculated on proved reserves only.
- Under Canadian GAAP, gains and losses were not calculated on asset dispositions unless a significant portion (generally 20 percent or more) of an asset pool was being disposed. Under IFRS, all asset disposals must be assessed to determine whether a gain or loss has occurred. As a result, the Company is reporting gains/losses on disposal of PP&E in its IFRS statement of earnings which were previously not reported under Canadian GAAP.
- Exploration and evaluation expenses encompass pre-licence costs, expired lands and bought seismic which are not capitalized.
- Share-based compensation expenses have been accelerated under IFRS as a result of the required use of a graded vesting schedule versus the straight-line method which was permitted under Canadian GAAP and the application of a forfeiture rate in the calculation under IFRS rather than recording forfeitures as incurred, which was permissible under Canadian GAAP.
- Future income taxes are now referred to as deferred taxes.

Further details on the impacts of the IFRS transition can be found in Note 25 to the interim unaudited consolidated financial statements.

SUMMARY OF SIGNIFICANT EVENTS IN THE FIRST QUARTER

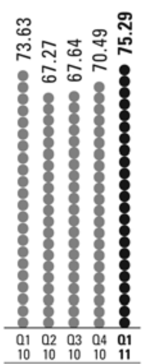
- The Company realized funds flow from operating activities of $15.22 million and declared dividends of $11.40 million ($9.65 million in cash after considering the common shares issued for the Dividend Reinvestment Plan, ("DRIP")) or $0.42 per common share to shareholders. For Canadian income tax purposes, all dividends paid or to be paid on Zargon's common shares are designated as "eligible dividends".
- Average field prices received (before the impact of financial risk management contracts) for oil and liquids and for natural gas increased seven percent to $75.29 per barrel and increased three percent to $3.55 per thousand cubic feet, respectively, compared to the fourth quarter of 2010.
- Production averaged 9,546 barrels of oil equivalent per day and was two percent higher than the preceding quarter and five percent lower than the corresponding 2010 quarter. Reflecting Zargon's continuing focus on oil exploitation initiatives, oil and liquids production averaged 5,893 barrels of oil per day in the first quarter, an eight percent increase over the prior quarter and a six percent increase over the corresponding 2010 quarter.

- Zargon completed property dispositions totalling $2.00 million. These disposition packages of minor non-core properties were part of Zargon's ongoing efforts to improve its operational footprint and focus.
- Eight gross oil wells (7.5 net) were drilled with a 100 percent success rate. Total field exploration and development capital expenditures (excluding corporate and net property dispositions) were $22.25 million for the quarter compared to $17.29 million for the prior quarter.
- At quarter end, debt net of working capital (excluding unrealized derivative assets/liabilities) was $135.13 million, a nine percent increase from $124.39 million at the end of the 2010 fourth quarter, which represented approximately 75 percent of the Company's available credit facilities at March 31, 2011.
- Subsequent to quarter end, Zargon closed an offering of 1.725 million common shares on a bought deal basis at $22.60 per share for total gross proceeds of $38.99 million ($36.93 million net of issue costs). The proceeds will be used to pay down debt and to partially fund the oil-focused 2011 capital program.

FINANCIAL ANALYSIS

First quarter 2011 gross petroleum and natural gas sales of $46.94 million were 10 percent higher than the $42.64 million in the fourth quarter of 2010 and three percent below the $48.46 million in the first quarter of 2010. First quarter 2011 realized oil and liquids field prices averaged $75.29 per barrel before the impact of financial risk management contracts and were seven percent higher than the preceding quarter's $70.49 per barrel and two percent higher than the $73.63 per barrel recorded in the 2010 first quarter. Zargon's crude oil field price differential from the Edmonton par price increased to $12.68 per barrel in the first quarter of 2011 compared to $9.85 per barrel in the fourth quarter of 2010. Natural gas field prices received averaged $3.55 per thousand cubic feet in the first quarter of 2011, a three percent increase from the preceding quarter and a 26 percent decrease from the 2010 first quarter prices.

OIL AND LIQUIDS PRICES ($/bbl)



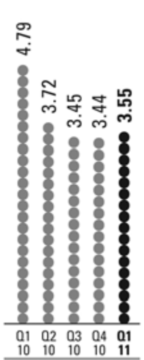
Pricing

	Three Months Ended March 31,		
Average for the period	**2011**	2010	Percent Change
Natural Gas:			
NYMEX average daily spot price ($US/mmbtu)	**4.18**	5.14	(19)
AECO average daily spot price ($Cdn/mmbtu)	**3.79**	4.97	(24)
Zargon realized field price ($Cdn/mcf)	**3.55**	4.79	(26)
Zargon realized natural gas field price differential/(premium) (1)	**0.24**	0.18	
Crude Oil:			
WTI ($US/bbl)	**94.03**	78.71	19
Edmonton par price ($Cdn/bbl)	**87.97**	80.07	10
Zargon realized field price before the impact of financial risk management contracts ($Cdn/bbl)	**75.29**	73.63	2
Zargon realized field price after the impact of financial risk management contracts ($Cdn/bbl)	**69.61**	76.03	(8)
Zargon realized oil field price differential (2)	**12.68**	6.44	

(1) Calculated as Zargon's realized field price ($Cdn/mcf) as compared to AECO average daily spot price ($Cdn/mmbtu). There were no financial risk management contracts in place for natural gas in either 2010 or 2011.

(2) Calculated as Zargon's realized field price before the impact of financial risk management contracts ($Cdn/bbl) as compared to Edmonton par price ($Cdn/bbl).

NATURAL GAS PRICES ($/mcf)



Natural gas production volumes decreased by six percent in the first quarter of 2011 to 21.92 million cubic feet per day from 23.28 million cubic feet per day in the fourth quarter of 2010 and were 19 percent lower than the 2010 first quarter. The decline in natural gas production is primarily a result of natural declines as Zargon has shifted its focus towards oil exploitation and has put its natural gas assets into runoff. Oil and liquids production volumes during the first quarter of 2011 were 5,893 barrels per day, which was eight percent above the 2010 fourth quarter rate of 5,437 barrels per day and six percent above the first quarter of 2010 level. The year-over-year increase in oil and liquids was primarily due to the oil exploitation focused horizontal well drilling programs. On a barrel of oil equivalent basis, Zargon produced 9,546 barrels of oil equivalent per day in the first quarter of 2011, a two percent increase from the fourth quarter 2010 and a five percent decrease from the first quarter 2010.

Production by Core Area

Three Months Ended March 31,	**2011**			2010		
	Oil and Liquids (bbl/d)	**Natural Gas (mmcf/d)**	**Equivalents (boe/d)**	Oil and Liquids (bbl/d)	Natural Gas (mmcf/d)	Equivalents (boe/d)
Alberta Plains North	**1,231**	**18.13**	**4,251**	1,280	24.53	5,368
Alberta Plains South	**1,750**	**3.15**	**2,276**	1,338	1.80	1,638
Williston Basin	**2,912**	**0.64**	**3,019**	2,936	0.72	3,056
	5,893	**21.92**	**9,546**	5,554	27.05	10,062

Zargon's commodity price risk management policy, which is approved by the Board of Directors, allows the use of derivatives such as forward sales, costless collars and other instruments up to a 24 month term for a 30 percent maximum of the combined oil and natural gas working interest production (subject to a 50 percent maximum limitation on any single commodity) in order to partially offset the effects of large commodity price fluctuations. Zargon's management considers financial risk management contracts to be effective on an economic basis, but has decided not to designate these contracts as hedges for accounting purposes and, accordingly, for these contracts, an unrealized gain or loss is recorded based on the fair value (mark-to-market) of the contracts at the period end. Realized and unrealized gains on risk management contracts are included in "gain/loss on derivatives" in the statement of earnings and their fair value is reflected in "derivative assets" or "derivative liabilities" on the balance sheet statement.

In the 2011 first quarter, relatively higher oil prices versus contract prices resulted in a net realized loss on derivatives of $3.01 million on oil contracts compared to a $1.94 million realized net loss in the fourth quarter of 2010 and a $1.18 million realized net gain in the first quarter of 2010.

The unrealized loss on derivatives of $13.83 million in the first quarter of 2011 resulted from oil contract losses of $13.88 million and electricity contract gains of $0.05 million, compared to a net $9.71 million loss for the 2010 fourth quarter and a net $3.33 million loss in the first quarter of 2010. These non-cash unrealized derivatives gains or losses are generated by the change over the reporting period in the mark-to-market valuation of Zargon's risk management contracts. Recent volatility in commodity prices has resulted in significant fluctuations in the mark-to-market amount of unrealized derivatives assets and liabilities. The period-over-period change in these valuations directly impacts net earnings. Zargon's commodity risk management positions are fully described in Note 5 to the unaudited interim consolidated financial statements.

Royalties totalled $7.57 million for the first quarter of 2011, an increase of three percent from the $7.33 million preceding quarter expense and a decrease of 16 percent from $8.96 million in the first quarter of 2010. The variations in royalty rates generally track changes in production volumes and prices. Reflecting the 2011 commodity prices and the modified royalty structure, on a consolidated basis, the first quarter of 2011 royalties resulted in a rate of 16.1 percent compared to 17.2 percent in the fourth quarter of 2010. For the remainder of the year, Zargon expects its royalty rate to remain in the 16 to 18 percent range, but it will ultimately depend on the actual price received for our production.

On a unit of production basis, production costs (excluding transportation costs) of $15.31 per barrel of oil equivalent in the first quarter of 2011 increased 17 percent from the preceding quarter and 20 percent from the $12.78 per barrel of oil equivalent in the first quarter of 2010. These additional costs were largely due to additional first quarter 2011 cold and snowy weather related charges, increased electricity costs and a prospective change in accounting estimate regarding the capitalization of workovers. Oil and natural gas liquids transportation costs in the first quarter of 2011 were $0.41 million, which compares to $0.28 million in the previous quarter and $0.27 million in the first quarter of 2010. Subsequent to the operating cost challenges in the second quarter of this year relating to flooding and surface access problems, production and transportation costs, combined, are expected to average approximately $15.00 per barrel of oil equivalent in the second half of the 2011 year.

Operating Netbacks

Three Months Ended March 31,	**2011**		2010	
	Oil and Liquids ($/bbl)	**Natural Gas ($/mcf)**	Oil and Liquids ($/bbl)	Natural Gas ($/mcf)
Sales	**75.29**	**3.55**	73.63	4.79
Royalties	**(12.77)**	**(0.40)**	(14.81)	(0.64)
Realized gain/(loss) on derivatives	**(5.68)**	**–**	2.40	–
Production costs	**(14.39)**	**(2.80)**	(12.85)	(2.12)
Transportation costs	**(0.77)**	**–**	(0.55)	–
Operating netbacks	**41.68**	**0.35**	47.82	2.03

Measured on a unit of production basis (net of recoveries), general and administrative (“G&A”) expenses were $4.12 per barrel of oil equivalent in the first quarter of 2011 compared to $3.95 in the first quarter of 2010 and $4.23 for the twelve month period of 2010. As total G&A expenses of $3.54 million for the first quarter of 2011 were essentially unchanged from total G&A expenses for the first quarter of 2010, the increase on a unit of production basis is due solely to the lower production volumes in the first quarter of 2011.

Zargon’s borrowings are through its syndicated bank credit facilities. Interest and financing charges on these facilities in the 2011 first quarter were $1.81 million, 28 percent higher than the previous quarter amount of $1.42 million and 69 percent higher than the $1.07 million in the first quarter of 2010. This year-over-year increase is primarily due to the below noted tax audit contingency provision as well as an increase in average borrowing levels and higher average borrowing costs.

Zargon is subject to normal course income tax audits by Canadian and US taxation authorities. During the fourth quarter of 2010, the Canada Revenue Agency (“CRA”) commenced a flow-through share audit of a predecessor company from a prior corporate acquisition. During the first quarter of 2011, Zargon recorded a $1.27 million provision which was comprised of a $0.92 million charge to current income tax expense and $0.35 million charge to interest expense for the related Part XII.6 tax, with respect to this ongoing income tax audit. At this time Zargon is uncertain of the timing and final outcome of this matter.

Current income taxes for the 2011 first quarter were $1.38 million, and relate to the United States operations in addition to the above mentioned tax contingency. When compared to prior periods, current income taxes increased $0.63 million from the 2010 first quarter and increased $1.12 million relative to the fourth quarter of 2010. Total corporate tax pools as at March 31, 2011, are approximately $354 million, which represents an increase of two percent from the comparable $346 million of tax pools available to Zargon at December 31, 2010, primarily as a result of the 2011 first quarter capital program.

Exploration and evaluation expenses for the 2011 first quarter of $0.86 million were $0.29 million lower than the $1.15 million incurred in the fourth quarter of 2010 mainly due to lower land expiries and were $0.35 million higher than the first quarter of 2010 expenses of $0.51 million mainly due to higher land expiries.

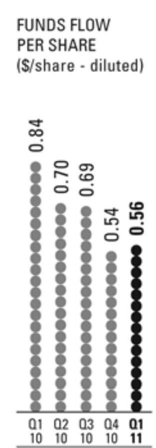
Corporate Netbacks

($/boe)	Three Months Ended March 31, 2011	2010
Petroleum and natural gas sales	**54.64**	53.51
Royalties	**(8.81)**	(9.90)
Realized gain/(loss) on derivatives	**(3.50)**	1.30
Production costs	**(15.31)**	(12.78)
Transportation costs	**(0.48)**	(0.30)
Operating netbacks	**26.54**	31.83
General and administrative	**(4.12)**	(3.95)
Exploration and evaluation expense – cash portion	**(0.24)**	(0.29)
Interest and financing charges	**(2.10)**	(1.18)
Asset retirement expenditures	**(0.76)**	(1.31)
Capital and current income taxes	**(1.61)**	(0.83)
Funds flow netbacks	**17.71**	24.27

Depletion and depreciation expense for the first quarter of 2011 increased nine percent to $12.78 million from $11.67 million in the prior quarter and increased five percent when compared to the first quarter of 2010 expense of $12.11 million. On a per barrel of oil equivalent basis, the depletion and depreciation rates were $14.87, $13.62 and $13.38 for the first quarter of 2011 and the fourth and first quarters of 2010, respectively. The 2010 calendar year depletion and depreciation rate was $13.65 per barrel of oil equivalent.

The accretion expense of asset retirement obligations for the first three months of 2011 was $0.80 million, a 15 percent increase compared to the first three months of 2010. The year-over-year increase is due to changes in the estimated future liability for asset retirement obligations as a result of wells added through Zargon's drilling program inclusive of wells acquired/disposed of in the current year and with the recent corporate/property acquisitions/dispositions.

Expensing of share-based compensation in the first quarter of 2011 totalled $0.58 million, which is higher than the $0.45 million incurred in the first quarter of 2010 mainly due to the new share-based plan implemented on January 1, 2011 in conjunction with the corporate conversion, but lower than the $1.00 million incurred in the fourth quarter of 2010 due to fair value changes driven by the increase in share price over the same period.

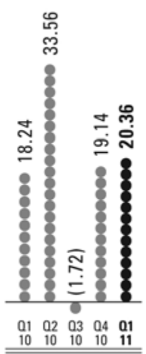


The deferred tax recovery for the first quarter of 2011 was $3.43 million compared to $6.96 million in the prior quarter and $2.10 million in the first quarter of 2010. As a corporation, Zargon's deferred tax obligations are no longer reduced by dividend declarations. Prior to 2011, as a trust, cash distributions were 100 percent deductible. This change in tax structure is the primary reason for the 2011 first quarter decrease in deferred tax recovery relative to the 2010 fourth quarter.

Funds flow from operating activities in the 2011 first quarter of $15.22 million was $0.81 million, or six percent higher than the preceding quarter and $6.76 million or 31 percent lower than the prior year first quarter. The decrease in funds flow compared to the prior year first quarter was primarily a result of a realized loss on derivatives in the first three months of 2011 as well as lower revenues and higher production expenses. Funds flow on a per diluted common share basis of $0.56 for the first quarter of 2011 is relatively unchanged from the prior quarter and is 33 percent lower than the 2010 first quarter.

Net losses of $9.11 million for the 2011 first quarter were significantly improved compared to $36.29 million of net losses in the preceding quarter, which had resulted largely from impairment losses driven by lower natural gas prices in the fourth quarter of 2010, but decreased from the $4.35 million of net earnings in the first quarter of 2010. The net losses in the first quarter of 2011 were primarily due to relatively large realized and unrealized losses on derivatives. The net earnings track the funds flow from operating activities for the respective periods modified by asset retirement expenditures and non-cash charges, which include depletion and depreciation, unrealized derivatives gains/losses, land expiries and deferred taxes. On a per diluted share basis, first quarter 2011 net losses were $0.33 compared to net losses of $1.35 for the 2010 fourth quarter and net earnings of $0.17 for the 2010 first quarter.

NET CAPITAL EXPENDITURES ($ millions)



Capital Expenditures

	Three Months Ended March 31,	
($ millions)	**2011**	2010
Undeveloped land	**1.39**	1.22
Geological and geophysical (seismic)	**0.51**	0.47
Drilling and completion of wells	**15.53**	8.15
Well equipment and facilities	**4.82**	4.73
Exploration and development	**22.25**	14.57
Property acquisitions	**0.06**	4.56
Property dispositions	**(2.00)**	(1.00)
Net property acquisitions/(dispositions)	**(1.94)**	3.56
Total net capital expenditures excluding administrative assets	**20.31**	18.13
Administrative assets	**0.05**	0.11
Total net capital expenditures	**20.36**	18.24

PROPERTY DISPOSITIONS

During the first quarter of 2011, Zargon completed property dispositions totalling $2.00 million, which resulted in a gain on disposition of $0.23 million. These dispositions are part of Zargon's ongoing plan of shedding outlying properties that are not within its focus.

SUBSEQUENT EVENT

On April 7, 2011, Zargon closed an offering of 1.725 million common shares on a bought deal basis at $22.60 per share for total gross proceeds of $38.99 million ($36.93 million net of issue costs). The proceeds will be used to pay down debt and to partially fund the oil-focused 2011 capital program.

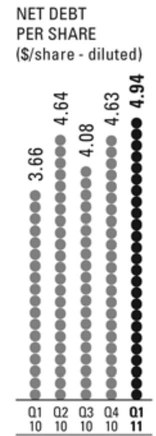
LIQUIDITY AND CAPITAL RESOURCES

Total net capital expenditures (including net property acquisitions) of $20.36 million in the first three months of 2011 were 12 percent higher than the same period in 2010. Field expenditures of $22.25 million for the first three months of 2011 reflected an increase when compared to $14.57 million for the same period in 2010 primarily due to continuing completions from the 2010-2011 winter drilling program which resulted in drilling and completion expenses of $15.53 million that were 91 percent higher than the prior year's first three months amount of $8.15 million. During the first three months of 2011, 7.5 net wells were drilled compared to 12.8 net wells in the same period in 2010. Field capital expenditures (excluding net property dispositions) for the first three months of 2011 were allocated to Alberta Plains North – $5.92 million, Alberta Plains South – $4.65 million and Williston Basin – $11.68 million. During the first three months of 2011, Zargon incurred $0.06 million of property acquisitions which were more than offset by dispositions of $2.00 million.

Funds flow from operating activities in the first three months of 2011 of $15.22 million, proceeds from the issuance of common shares of $2.82 million (due to share right exercises) and the increase in bank debt of $6.61 million funded the capital program, the changes in working capital and the cash dividends to the shareholders.

At March 31, 2011, the Company's combined debt net of working capital (excluding unrealized derivative assets/liabilities) was $135.13 million, and compares to $124.39 million of net debt at the end of the 2010 fourth quarter; however, with the aforementioned equity issuance occurring in April, this net debt balance was subsequently reduced by approximately $36.93 million.

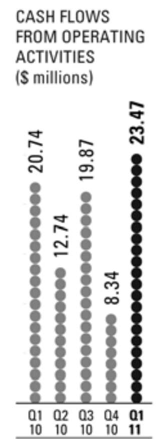
The volatility of oil and natural gas prices, uncertainty or modifications regarding royalties and Canadian income tax rules and global economic/political concerns have, on occasion, restricted the oil and natural gas industry's ability to attract new capital from debt and equity markets. Zargon's strategy of maintaining conservative debt levels should enable Zargon to continue its capital and dividend programs during periods of limited access to debt and equity capital.



Cash Dividends Analysis

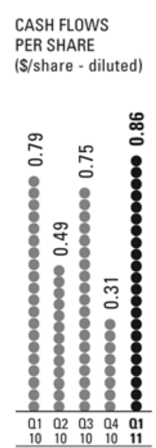
	Three Months Ended March 31,	
($ millions)	**2011**	2010
Cash flows from operating activities	**23.47**	20.74
Net earnings/(losses)	**(9.11)**	4.35
Actual cash dividends paid or payable relating to the period [(1)]	**(9.65)**	(12.55)
Excess of cash flows from operating activities over cash dividends paid	**13.82**	8.19
Excess (shortfall) of net earnings/(losses) over cash dividends paid	**(18.76)**	(8.20)

(1) *Cash dividends represent the cash portion only and do not include common shares issued through Zargon's Dividend Reinvestment Plan which commenced in April 2010. Note that for 2010, amounts relate to distributions under the income trust structure.*



During the first three months of 2011, Zargon has maintained a base monthly dividend of $0.14 per common share. Management monitors the Company's dividend policy with respect to forecasted net cash flows, debt levels and capital expenditures. Zargon's cash dividends are discretionary to the extent that these dividends are in compliance with Section 43 of the Business Corporations Act (Alberta) and do not cause a breach of the financial covenants under Zargon's credit facilities. As a crude oil and natural gas Company, Zargon's reserve base is depleted with production and Zargon, therefore, relies on ongoing exploration, development and acquisition activities to replace reserves and to offset production declines. The success of these exploration, development and acquisition capital programs, along with commodity price fluctuations and the Company's ability to manage costs, are the main factors influencing the sustainability of the Company's dividends.

For the three months ended March 31, 2011, cash flows from operating activities (after changes in non-cash working capital) of $23.47 million exceeded cash dividends of $9.65 million. Similarly, for the three months ended March 31, 2010, cash flows from operating activities (after changes in non-cash working capital) of $20.74 million exceeded cash distributions of $12.55 million.



For the three months ended March 31, 2011, cash dividends of $9.65 million exceeded net losses of $9.11 million. Net earnings include significant non-cash charges of $24.98 million for the 2011 first quarter that do not impact cash flow. For the three months ended March 31, 2010, cash distributions of $12.55 million exceeded net earnings of $4.35 million. Net earnings also include fluctuations in deferred taxes due to changes in tax rates and tax rules. In the instances where dividends exceed net earnings, a portion of the cash dividend paid to shareholders may represent an economic return of the shareholders' capital.

For the quarter ended March 31, 2011, cash dividends and net capital expenditures totalled $30.01 million, which was $6.54 million higher than the cash flows from operating activities (after changes in non-cash working capital) of $23.47 million. For the quarter ended March 31, 2010, cash distributions and net capital expenditures totalled $30.79 million, which was $10.05 million higher than the cash flows from operating activities (after changes in non-cash working capital) of $20.74 million. Zargon relies on access to debt and capital markets to the extent that cash dividends and net capital expenditures exceed cash flows from operating activities (after changes in non-cash working capital). Over the long term, Zargon expects to fund cash dividends and capital expenditures with its cash flows from operating activities; however, it will continue to fund acquisitions and growth through additional debt and equity issuances. In the crude oil and natural gas industry, because of the nature of reserve reporting, the natural reservoir declines and the risks involved in capital investment, it is not possible to distinguish between capital spent on maintaining productive capacity and capital spent on growth opportunities. Therefore, maintenance capital is not disclosed separately from development capital spending.

At May 12, 2011, Zargon Oil & Gas Ltd. had 29.029 million common shares outstanding. Pursuant to the common share rights incentive plans, there are currently an additional 1.256 million common share incentive rights issued and outstanding.

Capital Sources and Uses

	Three Months Ended March 31,	
($ millions)	**2011**	2010
Funds flow from operating activities	**15.22**	21.98
Change in bank debt	**6.61**	7.65
Issuance of common shares	**2.82**	1.79
Cash dividends to shareholders [(1)]	**(9.65)**	(12.55)
Changes in working capital and other	**5.36**	(0.63)
Total capital sources	**20.36**	18.24

(1) Cash dividends represent the cash portion only and do not include common shares issued through Zargon's Dividend Reinvestment Plan which commenced in April 2010. Note that for 2010, amounts relate to distributions under the income trust structure.

CHANGES IN ACCOUNTING POLICIES

Other than the changes previously discussed under "Transition to International Financial Reporting Standards" the Company had no changes in accounting policies in the quarter ended March 31, 2011.

FUTURE CHANGES IN ACCOUNTING POLICIES

IFRS 9, Financial Instruments, which was issued in October 2010, replaces IAS 39, Financial Instruments: Recognition and Measurement and establishes principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows. This new standard is effective for the Company's interim and annual consolidated financial statements commencing January 1, 2013. The Company is currently assessing the impact of this standard on its consolidated financial statements.

MANAGEMENT AND FINANCIAL REPORTING SYSTEMS

Zargon is required to comply with National Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings", otherwise referred to as Canadian SOX ("C-Sox"). The 2011 certificate requires that the Company disclose in the interim MD&A any changes in the Company's internal controls over financial reporting that occurred during the period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. The Company confirms that, other than the conversion to IFRS, no such changes were made to the internal controls over financial reporting during the first three months of 2011.

Because of their inherent limitations, internal controls over financial reporting may not prevent or detect misstatements, errors or fraud. Control systems, no matter how well conceived or operated, can provide only reasonable, not absolute assurance that the objectives of the control systems are met.

OUTLOOK

With a promising internally generated oil exploitation project inventory, Zargon continues to be well positioned to meet its value-creating and dividend generating objectives in the remainder of 2011 and beyond.

SUMMARY OF QUARTERLY RESULTS

	2010				**2011**
	Q1	Q2	Q3	Q4	**Q1**
Petroleum and natural gas sales, before royalties ($ millions)	48.46	43.89	44.50	42.64	**46.94**
Net earnings/(losses) ($ millions)	4.35	17.86	1.20	(36.29)	**(9.11)**
Net earnings/(losses) per diluted share ($)	0.17	0.68	0.05	(1.35)	**(0.33)**
Funds flow from operating activities ($ millions)	21.98	18.24	18.31	14.40	**15.22**
Funds flow from operating activities per diluted share ($)	0.84	0.70	0.69	0.54	**0.56**
Cash flows from operating activities ($ millions)	20.74	12.74	19.87	8.34	**23.47**
Cash flows from operating activities per diluted share ($)	0.79	0.49	0.75	0.31	**0.86**
Cash distributions/dividends ($ millions) (1)	12.55	11.88	11.92	10.99	**9.65**
Cash distributions/dividends declared per common share ($)	0.54	0.54	0.54	0.54	**0.42**
Net capital expenditures ($ millions) (2)	18.24	33.56	(1.72)	19.14	**20.36**
Total assets ($ millions)	466.94	495.98	481.90	472.25	**483.98**
Bank debt ($ millions)	84.23	114.12	97.61	115.29	**121.89**
Average daily production (boe)	10,062	10,050	10,094	9,317	**9,546**
Average realized commodity field price before the impact of financial risk management contracts ($/boe)	53.51	47.99	47.91	49.74	**54.64**
Funds flow netback ($/boe)	24.27	19.96	19.70	16.81	**17.71**

(1) Cash distributions/dividends represent the cash portion only and do not include trust units/common shares issued through Zargon's Distribution/Dividend Reinvestment Plan which commenced in April 2010.

(2) Third quarter 2010 expenditures include corporate acquisition amounts as follows; net debt assumed of $3.41 million and the equity issuance of common shares valued at $5.95 million.

	2009			
	Q1[3]	Q2[3]	Q3[3]	Q4[3]
Petroleum and natural gas sales, before royalties ($ millions)	31.98	35.84	40.96	47.21
Net earnings/(losses) ($ millions)	0.37	(2.55)	4.47	0.44
Net earnings/(losses) per diluted unit ($)	0.02	(0.13)	0.20	0.02
Funds flow from operating activities ($ millions)	17.85	20.92	22.84	24.75
Funds flow from operating activities per diluted unit ($)	0.84	0.91	0.90	0.95
Cash flows from operating activities ($ millions)	15.73	21.94	23.30	27.86
Cash flows from operating activities per diluted unit ($)	0.74	0.95	0.92	1.07
Cash distributions ($ millions)	10.03	11.26	12.22	12.45
Cash distributions declared per trust unit ($)	0.54	0.54	0.54	0.54
Net capital expenditures ($ millions) [1] [2]	13.44	48.96	29.32	12.87
Total assets ($ millions)	440.76	466.60	473.47	464.38
Bank debt ($ millions)	85.78	70.43	77.05	76.58
Average daily production (boe)	9,213	9,520	10,088	10,586
Average realized commodity field price before the impact of financial risk management contracts ($/boe)	38.57	41.37	44.13	48.48
Funds flow netback ($/boe)	21.53	24.14	24.61	25.43

(1) Second quarter 2009 expenditures include corporate acquisition amounts as follows; cash consideration of $5.70 million, transaction costs of $0.36 million, net debt assumed of $12.93 million and the equity issuance of trust units valued at $21.04 million.

(2) Third quarter 2009 expenditures include corporate acquisition amounts as follows; cash consideration of $0.11 million, transaction costs of $0.27 million, net debt assumed of $6.58 million and the equity issuance of trust units valued at $9.36 million.

(3) All 2009 figures are as reported under Canadian GAAP and are not adjusted for IFRS.

Additional information regarding the Company and its business operations, including the Company's Annual Information Form for December 31, 2010, is available on the Company's SEDAR profile at www.sedar.com.

"Signed" C.H. Hansen
President and Chief Executive Officer

Calgary, Alberta
May 12, 2011

CONSOLIDATED BALANCE SHEETS

(unaudited)

($ thousands)	Notes	**March 31, 2011**	December 31, 2010 (restated Note 25)	January 1, 2010 (restated Note 25)
ASSETS	14			
Trade and other receivables		**24,781**	22,883	25,223
Deposits and prepaid expenses		**2,096**	2,191	2,013
Derivatives	5	**–**	–	4,289
Total current assets		**26,877**	25,074	31,525
Long term deposits		**653**	653	1,845
Property, plant and equipment	7,11	**418,880**	412,119	400,119
Intangible exploration and evaluation assets	12	**27,560**	27,708	24,368
Goodwill	12	**2,969**	2,969	2,969
Deferred tax assets		**7,036**	3,723	2,075
Total non-current assets		**457,098**	447,172	431,376
Total assets		**483,975**	472,246	462,901
LIABILITIES				
Trade and other payables		**36,888**	30,431	34,507
Cash dividends/distributions payable	23	**3,227**	3,750	4,157
Derivatives	5	**21,379**	10,737	6,032
Exchangeable shares	17	**–**	–	56,211
Total current liabilities		**61,494**	44,918	100,907
Long term debt	14	**121,893**	115,285	76,580
Derivatives	5	**6,269**	3,080	1,270
Unit-based compensation liability		**–**	–	6,111
Provisions	19	**97,873**	96,395	80,620
Deferred tax liabilities		**4,527**	4,870	16,272
Total non-current liabilities		**230,562**	219,630	180,853
Total liabilities		**292,056**	264,548	281,760
Commitments and contingencies	5,14,16,19,20			
EQUITY				
Shareholders' capital	15	**206,271**	201,091	–
Unitholders' capital	15	**–**	–	188,840
Currency translation adjustment		**(1,636)**	(1,208)	–
Contributed surplus		**7,796**	7,815	–
Retained earnings/(deficit)		**(20,512)**	–	(7,699)
Total equity		**191,919**	207,698	181,141
Total equity and liabilities		**483,975**	472,246	462,901

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF EARNINGS AND COMPREHENSIVE INCOME

(unaudited)		For the three month period ending March 31,	
($ thousands, except per share amounts)	Notes	**2011**	2010 (restated Note 25)
REVENUE, net of royalties	8	**39,371**	39,492
EXPENSES			
Loss on unrealized derivatives	5	**13,831**	3,327
(Gain)/loss on realized derivatives	5	**3,009**	(1,180)
Production and operating expenses		**13,156**	11,574
Transportation expenses		**407**	274
Exploration and evaluation expenses		**862**	505
General and administrative expenses		**3,537**	3,577
Gain on disposal of properties		**(234)**	–
Exchangeable shares revaluation		**–**	4,081
Share-based compensation	16	**584**	449
Depletion and depreciation	11,13	**12,775**	12,113
		47,927	34,720
		(8,556)	4,772
FINANCE EXPENSES			
Interest and financing charges	20	**1,806**	1,070
Accretion of asset retirement obligations	19	**802**	700
		2,608	1,770
EARNINGS/(LOSSES) BEFORE INCOME TAXES		**(11,164)**	3,002
INCOME TAXES			
Current	20	**1,378**	748
Deferred tax recovery		**(3,430)**	(2,097)
		(2,052)	(1,349)
NET EARNINGS/(LOSSES) FOR THE PERIOD		**(9,112)**	4,351
OTHER COMPREHENSIVE INCOME/(LOSS)			
Currency translation adjustment, net of tax (1)		**(319)**	(449)
OTHER COMPREHENSIVE INCOME/(LOSS) FOR THE PERIOD		**(319)**	(449)
TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE PERIOD		**(9,431)**	3,902
NET EARNINGS/(LOSSES) PER SHARE			
Basic	18	**(0.34)**	0.19
Diluted	18	**(0.33)**	0.17

(1) Includes $0.11 million of tax for March 31, 2011 and $0.18 million of tax for March 31, 2010.

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(unaudited) For the three month period ending March 31,

($ thousands)	Notes	Shareholders' Capital	Currency Translation Adjustment	Contributed Surplus	Retained Earnings	Total Equity
Balance at January 1, 2011		**201,091**	**(1,208)**	**7,815**	**–**	**207,698**
Net earnings/(losses) for the period		**–**	**–**	**–**	**(9,112)**	**(9,112)**
Dividends declared	23	**–**	**–**	**–**	**(11,400)**	**(11,400)**
Issue of common shares pursuant to the DRIP	23,15	**1,751**	**–**	**–**	**–**	**1,751**
Share-based payments	16	**–**	**–**	**589**	**–**	**589**
Exercise of share options		**3,429**	**–**	**(608)**	**–**	**2,821**
Translation differences on foreign subsidiary		**–**	**(428)**	**–**	**–**	**(428)**
Balance at March 31, 2011		**206,271**	**(1,636)**	**7,796**	**(20,512)**	**191,919**
Balance at January 1, 2010 (restated, Note 25)		188,840	–	–	(7,699)	181,141
Net earnings/(losses) for the period		–	–	–	4,351	4,351
Dividends/distributions declared		–	–	–	(12,552)	(12,552)
Issue of common shares pursuant to the DRIP	15	2,799	–	–	–	2,799
Exercise of unit options		2,101	–	–	–	2,101
Translation differences on foreign subsidiary		–	(627)	–	–	(627)
Balance at March 31, 2010 (restated, Note 25)		193,740	(627)	–	(15,900)	177,213

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)		For the three month period ending March 31,	
($ thousands)	Notes	**2011**	2010
OPERATING ACTIVITIES			
Net earnings/(losses) for the period		**(9,112)**	4,351
Adjustments for non-cash items:			
Exchangeable shares revaluation		**–**	4,081
Gain on sale of properties		**(234)**	–
Change in fair value of unrealized derivatives		**13,831**	3,327
Depletion and depreciation		**12,775**	12,113
Accretion of asset retirement obligations		**802**	700
Share-based compensation		**584**	449
Deferred tax recovery		**(3,430)**	(2,097)
Exploration and evaluation expenses		**655**	243
Asset retirement expenditures		**(655)**	(1,188)
		15,216	21,979
Changes in operating working capital	9	**8,257**	(1,239)
Net cash from operating activities		**23,473**	20,740
INVESTING ACTIVITIES			
Additions to property, plant and equipment		**(21,788)**	(18,789)
Additions to intangible exploration and evaluation assets		**(574)**	(686)
Proceeds on disposal of property, plant and equipment		**1,996**	1,000
Changes in investing working capital	9	**(2,364)**	(32)
Net cash used in investing activities		**(22,730)**	(18,507)
FINANCING ACTIVITIES			
Advances of bank debt		**6,608**	7,649
Cash dividends/distributions paid to shareholders		**(9,649)**	(12,551)
Proceeds from exercise of share rights		**2,821**	1,793
Changes in financing working capital	9	**(523)**	876
Net cash used in financing activities		**(743)**	(2,233)
Change in cash and cash equivalents		**–**	–
Cash and cash equivalents, beginning of period		**–**	–
CASH AND CASH EQUIVALENTS, END OF PERIOD		**–**	–

See accompanying notes to the interim consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the three month period ended March 31, 2011, with comparative figures for 2010 (unaudited).

1. REPORTING ENTITY

Zargon Oil & Gas Ltd. ("the Company" or "Zargon") is a publicly traded corporation incorporated in Canada with its head office located in Calgary, Alberta. The interim consolidated financial statements of the Company as at and for the periods ended March 31, 2011 and its 2010 restated comparative periods comprise the Company and its wholly owned subsidiaries. The Company is engaged in the exploration for and development and production of oil and natural gas in Canada and the United States ("US") and conducts many of its activities jointly with others; these financial statements reflect only the Company's proportionate interest in such activities.

On December 31, 2010, Zargon Energy Trust (the "Trust") completed the conversion from an income trust into Zargon, a dividend paying corporation, pursuant to a Plan of Arrangement (the "Arrangement") under the Business Corporations Act (Alberta). Under the Arrangement, unitholders received, for each trust unit held, one common share of the Company. Exchangeable shareholders received 1.84716 common shares of the Company for each exchangeable share held as determined in accordance with the terms of the Arrangement. As a result, at December 31, 2010, Zargon had 27.05 million common shares issued and outstanding and no remaining exchangeable shares. There were no changes to the underlying business of the Company and the Board of Directors and senior management remained unchanged. Additional information regarding the Arrangement can be found in the Information Circular dated November 10, 2010.

The conversion of the Trust into a corporation has been accounted for using the continuity of interest method. Accordingly, the consolidated financial statements for the year ended December 31, 2010 reflect the financial position, results of operations and cash flows as if the Company had always carried on the business of the Trust. For the convenience of the reader, when discussing prior periods, the consolidated financial statements, where appropriate, refer to common shares, shareholders, share rights and dividends although for the pre-conversion period such items were trust units, unitholders, trust unit rights and distributions, respectively.

Pursuant to the Arrangement, the shareholders' capital was reduced by the amount of the deficit on December 31, 2010 of $71.34 million.

2. BASIS OF PRESENTATION AND ADOPTION OF IFRS

(a) Statement of compliance:

In 2010, the "CICA Handbook" was revised to incorporate International Financial Reporting Standards ("IFRS"), and requires publicly accountable enterprises to apply such standards effective for years beginning on or after January 1, 2011. Accordingly, the Company has commenced reporting on this basis in these condensed interim consolidated financial statements. In these financial statements, the term "Canadian GAAP" refers to Canadian generally accepted accounting principles before the adoption of IFRS.

These interim consolidated financial statements have been prepared in accordance with IFRS applicable to preparation of interim financial statements, including IAS 34 *Interim Financial Reporting* and IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Subject to certain transition elections disclosed in Note 25, the Company has consistently applied the same accounting policies in its opening IFRS balance sheet at January 1, 2010 and throughout all periods presented, as if these policies had always been in effect. Note 25 discloses the impact of the transition to IFRS on the Company's reported balance sheet, statement of earnings and cash flows, including the nature and effect of significant changes in accounting policies from those used in the Company's consolidated financial statements for the year ended December 31, 2010. Comparative figures for 2010 in these financial statements have been restated to give effect to these changes.

The policies applied in these interim consolidated financial statements are based on IFRS issued and outstanding as of May 12, 2011, the date the Board of Directors approved the statements. Any subsequent changes to IFRS that are given effect in the Company's annual consolidated financial statements for the year ending December 31, 2011 could result in restatement of these interim consolidated financial statements, including the transition adjustments recognized on change-over to IFRS.

The interim consolidated financial statements should be read in conjunction with the Company's Canadian GAAP annual financial statements for the year ended December 31, 2010.

(b) Basis of measurement:

The interim consolidated financial statements have been prepared on the historical cost basis except for derivative financial instruments measured at fair value. The methods used to measure fair values are discussed in Note 4.

(c) Functional and presentation currency:

Items included in the financial statements of each consolidated entity are measured using the currency of the primary economic environment in which the entity operates (the “functional currency”). The interim consolidated financial statements are presented in Canadian dollars, which is Zargon’s functional currency.

The financial statements of subsidiaries that have a functional currency different from that of Zargon (“foreign operations”) are translated into Canadian dollars as follows: assets and liabilities - at the closing rate at the date of the balance sheet, and income and expenses - at the average rate of the period (as this is considered a reasonable approximation to actual rates). All resulting changes are recognized in other comprehensive income as currency translation adjustments.

When Zargon disposes of its entire interest in a foreign operation, or loses control, joint control, or significant influence over a foreign operation, the foreign currency gains or losses accumulated in other comprehensive income related to the foreign operation are recognized in earnings. If Zargon disposes of part of an interest in a foreign operation which remains a subsidiary, a proportionate amount of foreign currency gains or losses accumulated in other comprehensive income related to the subsidiary are reallocated between controlling and non-controlling interests.

(d) Use of estimates and judgements:

The preparation of financial statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

Information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amounts recognized in the consolidated interim financial statements is included in the following notes:

- Note 5 – valuation of derivatives
- Note 7 – business combinations
- Note 11 – valuation of property, plant and equipment
- Note 12 – valuation of intangible exploration and evaluation assets and goodwill
- Note 16 – measurement of share-based payments
- Note 19 – provisions
- Note 20 – contingencies and commitments reserve estimates impact a number of the areas referred to above - in particular, the valuation of property, plant and equipment and the calculation of depletion and depreciation.

3. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to all periods presented in these consolidated interim financial statements and in preparing the opening IFRS consolidated balance sheet as at January 1, 2010 for the purposes of the transition to IFRS unless otherwise indicated. These accounting policies have been applied consistently by the Company.

Certain comparative amounts have been reclassified to conform to the current year's presentation. Refer to Note 25 for a discussion of items that have been reclassified.

(a) Basis of consolidation:

(i) Subsidiaries:

Subsidiaries are entities controlled by the Company. Control exists when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

The purchase method of accounting is used to account for acquisitions of subsidiaries and assets that meet the definition of a business under IFRS. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the identifiable assets, liabilities and contingent liabilities acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognized immediately in the statement of earnings and comprehensive income.

(ii) Jointly controlled operations and jointly controlled assets:

A joint venture is a contractual arrangement whereby two or more parties (venturers) undertake an economic activity that is subject to joint control. Joint control exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the venturers. Many of the Company's oil and natural gas activities involve jointly controlled assets. The consolidated financial statements include the Company's share of these jointly controlled assets and a proportionate share of the relevant revenue and related costs.

(iii) Transactions eliminated on consolidation:

Intercompany balances and transactions, and any unrealized income and expenses arising from intercompany transactions, are eliminated in preparing the interim consolidated financial statements.

(b) Foreign currency:

(i) Transactions and balances

Transactions in foreign currencies are translated to Canadian dollars at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated to Canadian dollars at the period end exchange rate. Foreign currency differences arising on translation are recognized in earnings.

(ii) Group companies

The assets and liabilities of foreign operations are translated at the rate of exchange prevailing at the reporting date and their statements of earnings are translated at exchange rates prevailing at the dates of the transactions. The exchange differences arising on the translation are recognized in equity. On disposal of a foreign operation, the component of other comprehensive income relating to that particular foreign operation is recognized in the statement of earnings and comprehensive income.

Any goodwill arising on the acquisition of a foreign operation subsequent to January 1, 2010 and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition are treated as assets and liabilities of the foreign operation and translated at the closing rate.

(c) 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 have been transferred and the Company has transferred substantially all risks and rewards of ownership.

Financial assets and liabilities are offset and the net amount reported in the 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.

At initial recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instruments were acquired:

(i) Non-derivative financial instruments:

Non-derivative financial instruments comprise trade and other receivables, cash and cash equivalents, bank overdrafts, loans and borrowings, and trade and other payables. Non-derivative financial instruments are recognized initially at fair value plus, for instruments not at fair value through earnings, any directly attributable transaction costs. Subsequent to initial recognition non-derivative financial instruments are measured as described below.

Cash and cash equivalents:

Cash and cash equivalents comprise cash on hand, term deposits held with banks and other short-term highly liquid investments with original maturities of three months or less. Bank overdrafts that are repayable on demand and form an integral part of the Company's cash management, whereby management has the ability and intent to net bank overdrafts against cash, are included as a component of cash and cash equivalents for the purpose of the statement of cash flows.

Financial assets at fair value through earnings:

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

Other:

Other non-derivative financial instruments, such as trade and other receivables, loans and borrowings, and trade and other payables, are measured at amortized cost using the effective interest method, less any impairment losses.

(ii) Derivative financial instruments:

Derivative financial instruments are utilized to reduce commodity price risk associated with the Company's production of oil and natural gas. The base prices for the commodities are sometimes denominated in US dollars and the Company may also use such financial instruments to reduce the related foreign currency risk. Financial instruments may also be used from time to time to reduce interest rate risk on outstanding debt. The Company does not enter into financial instruments for trading or speculative purposes.

The Company follows a policy of using risk management instruments such as fixed price swaps, forward sales, puts and costless collars. The objective is to partially offset or mitigate the wide price swings commonly encountered in oil and natural gas commodities and in so doing protect a minimum level of cash flow in periods of low commodity prices.

Electricity price contracts are utilized to hedge anticipated purchases of electricity to manage the Company's exposure to price fluctuations, which impact production and operating expenses.

The Company considers these financial risk management contracts to be effective on an economic basis but has decided not to designate these contracts as hedges for accounting purposes and, accordingly, for outstanding contracts not designated as hedges, an unrealized gain or loss is recorded based on the change in fair value ("mark-to-market") of the contracts at each reporting period end. These instruments have been recorded as derivative financial instruments in the consolidated balance sheet.

In the case of forward sales, the instrument can sometimes be satisfied by physical delivery. In the case of physical delivery, the payment/receipt is recorded as part of the normal revenue stream.

Foreign currency collar and swap agreements are utilized to manage the risk inherent in producing commodities whose price is based directly or indirectly on US dollars, using notional principal amounts equal to the projected monthly revenue from their sale. Payments or charges are calculated and paid according to the terms of the agreement, usually with monthly settlement.

(d) Property, plant and equipment and intangible exploration and evaluation assets:

(i) Recognition and measurement:

Exploration and evaluation expenses:

The Company accounts for exploration and evaluation ("E&E") costs, having regard to the requirements of IFRS 6 "Exploration for and Evaluation of Mineral Resources." Undeveloped land is accounted for as exploration and evaluation assets on the balance sheet. Pre-license E&E costs, lease expiries and purchased seismic are recognized in the statement of earnings as incurred. Costs of exploring for and evaluating oil and natural gas properties are capitalized and the resulting intangible E&E assets are tested for impairment by grouping with producing cash-generating units ("CGUs"). The level at which E&E assets are grouped with producing CGUs must not be larger than the Company's operating segments.

E&E costs related to each license/prospect are initially capitalized within "intangible exploration and evaluation assets". Such E&E costs may include costs of license acquisition, technical services and studies, seismic acquisition, exploration drilling and testing, directly attributable overhead and administrative expenses, including remuneration of production personnel and supervisory management, and the projected costs of retiring the assets (if any), but do not include general prospecting or evaluation costs incurred prior to having obtained the legal rights to explore an area, which are expensed directly to earnings as they are incurred.

E&E assets are not depleted and are carried forward until technical feasibility and commercial viability of extracting an oil or natural gas resource is considered to be determined. The technical feasibility and commercial viability of extracting a mineral resource is considered to be determined when proved and/or probable reserves are determined to exist. A review of each exploration licence or field is carried out, at least annually, to ascertain whether proved and/or probable reserves have been discovered.

Upon determination of proved and probable reserves, E&E assets attributable to those reserves are first tested for impairment at the CGU level, and then reclassified from E&E assets to property, plant and equipment.

Development & production costs:

Items of property plant and equipment, which include oil and natural gas development and production ("D&P") assets, are measured at cost less accumulated depletion and accumulated impairment losses. D&P assets are grouped into CGU's for impairment testing.

Expenditures on the construction, installation or completion of infrastructure facilities such as processing facilities, pipelines and the drilling of development wells, including unsuccessful development or delineation wells, are capitalized within D&P assets, as long as the facts and circumstances indicate that it is technically feasible and economically viable to extract identified reserves.

The initial cost of an asset comprises its purchase price or construction cost, any costs directly attributable to bringing the asset into operation, the initial estimate of the asset retirement obligation, and for qualifying assets, borrowing costs. The purchase price or constructed cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset.

Capitalized oil and natural gas interests generally represent costs incurred in developing proved and/or probable reserves and bringing in or enhancing production from such reserves, and are accumulated on a field or geotechnical area basis. Development expenditure is net of proceeds from the sale of oil and natural gas extracted during the development phase.

Exchanges of assets are measured at fair value unless the exchange transaction lacks commercial substance or the fair value of neither the asset received nor the asset given up is reliably measureable. The cost of the acquired asset is measured at the fair value of the asset given up, unless the fair value of the asset received is more clearly evident. Where fair value is not used, the cost of the acquired asset is measured at the carrying amount of the asset given up. The gain or loss on derecogniton of the asset given up is recognized in earnings.

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.

Other items of property, plant and equipment are carried at cost less accumulated depreciation and accumulated impairment losses.

(ii) Subsequent costs:

Costs incurred subsequent to the determination of technical feasibility and commercial viability are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost can be measured reliably. The carrying amount of a replaced asset is derecognized when replaced. Routine repairs and maintenance costs are charged to earnings during the period in which they are incurred.

(iii) Depletion and depreciation:

The net carrying value of development or production assets is depleted using the unit of production method by reference to the ratio of production in the year to the related proved and probable reserves, taking into account estimated future development costs necessary to bring those reserves into production. Future development costs are estimated taking into account the level of development required to produce the reserves. These estimates are reviewed by independent reserve engineers at least annually.

Proved and probable reserves are estimated using independent reserve engineer reports 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 viable. There should be a 50 percent statistical probability that the actual quantity of recoverable reserves will be more than the amount estimated as proven and probable and a 50 percent statistical probability that it will be less. The equivalent statistical probabilities for the proven component of proven and probable reserves are 90 percent and 10 percent, respectively.

Such reserves may be considered commercially producible if management has the intention of developing and producing them and such intention is based upon:

- a reasonable assessment of the future economics of such production;
- a reasonable expectation that there is a market for all or substantially all the expected oil and natural gas production; and
- evidence that the necessary production, transmission and transportation facilities are available or can be made available.

Reserves may only be considered proven and probable if producibility is supported by either actual production or a conclusive formation test. The area of reservoir considered proven includes (a) that portion delineated by drilling and defined by gas-oil and/or oil-water contacts, if any, or both, and (b) the immediately adjoining portions not yet drilled, but which can be reasonably judged as economically productive on the basis of available geophysical, geological and engineering data. In the absence of information on fluid contacts, the lowest known structural occurrence of oil and natural gas controls the lower proved limit of the reservoir.

Routine turnarounds are depreciated and recognized in earnings over the period until the next turnaround is expected to be required. Turnarounds have an estimated life of two years and are depreciated over a two year life.

For other assets, depreciation is recognized in earnings on a declining balance basis at an annual rate of 20 percent over the estimated useful lives of each item of property, plant and equipment. Leased assets are depreciated over the shorter of the lease term and their useful lives unless it is reasonably certain that the Company will obtain ownership by the end of the lease term. Depreciation methods, useful lives and residual values are reviewed at each reporting date.

(e) Business combinations and goodwill:

Business combinations from January 1, 2010

Business combinations are accounted for using the acquisition method. The cost of an acquisition is measured as the aggregate of the consideration transferred, measured at the acquisition date fair value and the amount of any non-controlling interest in the acquiree. For each business combination, Zargon measures the non-controlling interest in the acquiree either at fair value or at the proportionate share of the acquiree's identifiable net assets. Acquisition costs incurred are expensed.

When Zargon acquires a business, it assesses the financial assets and liabilities assumed for appropriate classification and designation in accordance with the contractual terms, economic circumstances and pertinent conditions as at the acquisition date.

If the business combination is achieved in stages, the acquisition date fair value of Zargon's previously held equity interest in the acquiree is re-measured to fair value at the acquisition date through earnings.

Any contingent consideration to be transferred by the acquirer will be recognized at fair value at the acquisition date. Subsequent changes to the fair value of the contingent consideration which is deemed to be an asset or liability, will be recognized in accordance with IAS 39 Financial Instruments: Recognition and Measurement either in earnings or as a change to other comprehensive income. If the contingent consideration is classified as equity, it should not be re-measured until it is finally settled within equity.

Goodwill is initially measured at cost being the excess of the aggregate of the consideration transferred and the amount recognized for non-controlling interest over the net identifiable assets acquired and liabilities assumed. If this consideration is lower than the fair value of the net assets of the subsidiary acquired, the difference is recognized in earnings.

Subsequent to initial recognition, goodwill is measured at cost less any accumulated impairment losses. For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Company's CGUs that are expected to benefit from the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

Where goodwill forms part of a CGU and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the CGU retained.

Business combinations prior to January 1, 2010:

As part of its transition to IFRS, the Company elected to restate only those business combinations that occurred on or after January 1, 2010. In respect of acquisitions prior to January 1, 2010, in comparison to the above-mentioned requirements, the following main differences applied:

Business combinations were accounted for using the purchase method. Transaction costs directly attributable to the acquisition formed part of the acquisition costs. The non-controlling interest was measured at the book value of the acquiree's identifiable net assets.

Business combinations achieved in stages were accounted for as separate steps. Any additional acquired share of interest did not affect previously recognized goodwill.

Contingent consideration was recognized when the amount could be reasonably estimated and the outcome was determinable beyond reasonable doubt. Otherwise, contingent consideration was recognized when resolved. Subsequent adjustments to the contingent consideration were recognized as part of goodwill.

(f) Leased assets

Leases where the Company assumes substantially all the risks and rewards of ownership are classified as finance leases. All other leases are classified as operating leases, which are not recognized on the Company's balance sheet. Zargon has no finance leases at this time.

Payments made under operating leases are recognized in earnings on a straight-line basis over the term of the lease. Lease incentives received are recognized as an integral part of the total lease expense, over the term of the lease.

(g) Impairment:

(i) 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 the amortized cost of the loan or receivable and the present value of the estimated future cash flows, discounted using the instrument's original effective interest rate. The carrying amount of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

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 earnings.

An impairment loss on financial assets carried at amortized cost 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 earnings.

(ii) 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. If any such indication exists, then the asset's recoverable amount is estimated. For goodwill, an impairment test is completed at least annually. E&E assets are assessed for impairment when they are reclassified to property, plant and equipment, as D&P assets, and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For the purpose of impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows that are largely independent of the cash inflows of other assets or groups of assets (the "cash-generating unit" or "CGU"). 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.

In assessing value-in-use, the estimated future cash flows from production of proved and probable reserves 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. In determining fair value less costs to sell, recent market transactions are taken into account, if available. If no such transactions can be identified, an appropriate discounted cash flow valuation model is used. These calculations are corroborated by valuation multiples or other available fair value indicators.

An impairment loss is recognized if the carrying amount of an asset or CGU exceeds its recoverable amount. Impairment losses are recognized in earnings. Impairment losses recognized in respect of CGUs are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amounts of the other assets in the unit (group of units) 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.

(h) Share-based payments:

Under the Company's share award and option plans (the "Plans"), options to purchase common shares were granted to directors, officers, employees and other service providers at market prices. The grant date fair value of options granted to employees is recognized as share-based compensation expense with a corresponding increase in contributed surplus. The total amount to be expensed is determined by reference to the fair value of the options granted, excluding the impact of any non-market service and performance vesting conditions. Non market vesting conditions are included in assumptions about the number of options that are expected to vest. When options vest in instalments over the vesting period, each instalment is accounted for as a separate arrangement. A forfeiture rate is estimated on the grant date, and at each reporting date, The Company revises its estimates of the number of options that are expected to vest.

Note that in 2010, prior to the corporate conversion discussed in Note 1, the rights were classified as a liability measured at fair value each reporting period. Changes in the fair value of the rights were recognized as share-based compensation expense with a corresponding increase in the unit-based compensation liability. At the effective date of conversion to a Company, the unit-based compensation liability was transferred to contributed surplus and the remainder of the fair value of the equity-settled award, measured as at the date of conversion, will be recognized in earnings over the remaining vesting period, with a corresponding increase in contributed surplus.

(i) 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. Where the Company expects some or all of the provision to be reimbursed, for example under an insurance contract, the reimbursement is recognized as a separate asset but only when the reimbursement is virtually certain. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. Provisions are not recognized for future operating losses.

Asset retirement obligations:

The Company's activities give rise to dismantling, decommissioning and site restoration activities (often referred to as asset retirement obligations). A provision is made for the estimated cost of site restoration and capitalized in the relevant asset category. The capitalized amount is depleted on the unit of production method based on proved and probable reserves.

Asset retirement obligations are measured at the present value of management's best estimate of expenditures 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 the estimated discount rate are capitalized. Actual costs incurred upon settlement of the asset retirement obligations are charged against the provision to the extent the provision was established.

(j) Revenue:

Revenue from the sale of crude oil, natural gas and natural gas liquids is recorded when the significant risks and rewards of ownership of the product is transferred to the buyer, which is usually when legal title passes to the external party. This is generally at the plant gate, which is the pipeline delivery point for natural gas and at the contracted delivery point for crude oil. Revenue is measured net of discounts, customs duties and royalties. With respect to the latter, the entity is acting as a collection agent on behalf of others.

Tariffs and tolls charged to other entities for use of pipelines and facilities owned by the Company are recognized as revenue as they accrue in accordance with the terms of the service or tariff and tolling agreements.

Royalty income is recognized as it accrues in accordance with the terms of the overriding royalty agreements.

(k) Finance expenses:

Finance expense comprises interest expense on borrowings and accretion of the discount on provisions.

Borrowing costs, which consist of interest expense 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 profit or 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 earnings, using the effective interest method.

Foreign currency gains and losses, reported under finance income and expenses, are reported on a net basis.

(l) Income tax:

Income tax expense comprises current and deferred tax. Income tax expense is recognized in earnings 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 and, at the time of the transaction, affects neither the accounting profit nor taxable profit. 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 by 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 the Company intends to settle current tax liabilities and assets on a net basis or the tax assets and liabilities will be realized simultaneously.

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.

Deferred tax assets and liabilities are presented as non-current.

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

(m) Earnings per share:

Basic earnings per share is calculated by dividing net earnings for the period by the weighted average number of common shares outstanding during the period. Diluted earnings per share is calculated by dividing the net earnings by the weighted average number of common shares outstanding during the year plus the weighted average number of common shares that would be issued if all the dilutive potential common shares into common shares. In 2011 dilutive potential common shares consist of share-based compensation expense for which dilution is determined by assuming that the proceeds received from “in-the-money” common share rights and unrecognized future share-based compensation expense are used to repurchase common shares at the average market rate during the period. However, prior to December 31, 2010, dilutive potential common shares also include exchangeable shares for which dilution was determined using the “if-converted” method, whereby it is assumed the conversion of the exchangeable shares occurs at the beginning of the reporting period (or at the time of issuance if later).

(o) Cash dividends/distributions:

Commencing in 2011, the Company declares monthly dividends of cash to shareholders of record on the last day of each calendar month. Pursuant to the Company’s policy, it will pay dividends to its shareholders subject to satisfying its financing covenants and the requirements of the Business Corporation Act (Alberta). Such dividends are recorded as distributions of equity upon declaration of the dividend. In prior years, the Trust declared monthly distributions of cash to unitholders of record on the last day of each calendar month. Pursuant to the Trust policy, it paid distributions to its unitholders subject to satisfying its financing covenants. Such distributions were recorded as distributions of equity.

(p) Segment reporting:

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The Chief operating decision-maker, who is responsible for allocating resources and assessing performance of the operating segments, has been identified as the chief executive officer that makes strategic decisions.

An operating segment is a component of the Company that engages in business activities from which it may earn revenue and incur expenses, including revenue and expenses that relates to transactions with any of the Company’s other components.

Segment results that are reported directly to the chief operating decision-maker include items directly attributable to a segment as well as those that have been allocated on a reasonable basis.

(q) Changes in accounting policy and disclosure

(i) New and amended standards adopted by the Company

Refer to Note 25.

(ii) Standards, amendments and interpretations to existing standards that are not yet effective and have not been early adopted by the Company

- IFRS 9, Financial Instruments, which was issued in October 2010, replaces IAS 39, Financial Instruments: Recognition and Measurement and establishes principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows. This new standard is effective for the Company's interim and annual consolidated financial statements commencing January 1, 2013. The Company is currently assessing the impact of this standard on its consolidated financial statements.

4. SIGNIFICANT ACCOUNTING JUDGMENTS, ESTIMATES AND ASSUMPTIONS

The preparation of the Company's consolidated financial statements requires management to make judgments, estimates and assumptions that affect the reported amounts of revenues, expenses, assets and liabilities, and the disclosure of contingent liabilities at the end of the reporting period. However, uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of the asset or liability affected in future periods.

When applicable, further information about the significant accounting judgments, estimates and assumptions made in preparing the consolidated financial statements is disclosed in the notes specific to that item.

(i) Property, plant and equipment and intangible exploration and evaluation assets:

Property, plant and equipment and intangible exploration and evaluation assets, represents costs incurred in developing oil and natural gas reserves and maintaining or enhancing production from such reserves. The fair value of property, plant and equipment recognized in a business combination is based on market values. The market value of property, plant and equipment is the estimated amount for which property, plant and equipment could be exchanged on the acquisition date between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The amount recorded for depletion and depreciation of property and equipment and the assessment of these assets for impairment including exploration assets are based on estimates of proved and probable reserves, production rebates, oil and natural gas prices, future costs and other relevant assumptions. All of Zargon's petroleum and natural gas reserves are evaluated and reported by independent engineering consultants in accordance with Canadian Securities Administrators' National Instrument 51-101 ("NI 51-101"). The estimation of reserves is a subjective process. Forecasts are based on engineering data, projected future rates of production, commodity prices and the timing of future expenditures, all of which are subject to numerous uncertainties and various interpretations. The Company expects that its estimates of reserves will change to reflect updated information. Reserves estimates can be revised upward or downward based on the results of future drilling, testing, production levels and changes in costs and commodity prices. By their nature, these estimates are subject to measurement uncertainty and the impact on the consolidated financial statement of changes in such estimates in future periods could be material.

(ii) Asset retirement obligation:

Inherent in the calculation of asset retirement obligations are numerous assumptions and judgements including the ultimate settlement amounts, inflation factors, risk-free discount rates, timing of settlement and changes in the legal and regulatory environments. To the extent future revisions to these assumptions impact the measurement of the existing asset retirement obligation liability, a corresponding adjustment is made to the property, plant and equipment balance. The risk-free discount rate is based on the approximate government of Canada long term bond rate.

(iii) Fair value of financial instruments:

Where the fair value of certain financial assets and financial liabilities recorded in the balance sheet cannot be derived from active markets, their fair value is determined using valuation techniques including the discounted cash flow model. The inputs to these models are taken from observable markets where possible, but where this is not feasible, a degree of judgment is required in establishing fair values. The judgments include considerations of inputs such as liquidity risk, credit risk and volatility. Changes in assumptions about these factors could affect the reported fair value of financial instruments.

Accounts receivable are designated as “loans and receivables”. Accounts payable and accrued liabilities, cash dividends/distributions payable and long term debt are designated as “other liabilities”. The fair values of these accounts approximate their carrying amounts.

Derivative assets and liabilities are derivative financial instruments classified as “held-for-trading”. These accounts are recorded at their fair value using quoted market prices.

Financial instruments of the Company carried on the consolidated balance sheets are carried at amortized cost with the exception of risk management contracts, which are carried at fair value.

All of the Company’s risk management contracts are transacted in active markets. The Company classifies the fair value of these transactions according to the following hierarchy based on the amount of observable inputs used to value the instrument.

- Level I

Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

- Level II

Pricing inputs are other than quoted prices in active markets included in Level I. Prices in Level II are either directly or indirectly observable as of the reporting date. Level II valuations are based on inputs, included quoted forward prices for commodities, time value and volatility factors, which are can be substantially observed or corroborated in the marketplace.

- Level III

Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

The Company’s risk management contracts have been assessed on the fair value hierarchy described above and are classified as Level II. Assessment of the significance of a particular input into the fair value measurement requires judgment and may affect the placement within the fair value hierarchy level.

(iv) Share-based compensation:

The Company measures the cost of equity-settled transactions with employees by reference to the fair value of the equity instruments at the date at which they are granted. The fair value of share awards is measured by reference to the quoted market price of the shares on the date of grant. The fair value of stock options is measured using a Black Scholes option pricing model. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility (based on weighted average historic volatility adjusted for changes expected due to publicly available information), weighted average expected life of the instruments (based on historical experience and general option holder behaviour), expected dividends, and the risk-free interest rate (based on government of Canada bonds).

5. DERIVATIVES

The Company is exposed to financial risks arising from its financial assets and liabilities. The financial risks include market risk (commodity prices, interest rates and foreign exchange rates), credit risk and liquidity risk.

- Market Risk

  Market risk is the risk that the fair value of future cash flows of financial assets or liabilities will fluctuate due to movements in market prices and is comprised of the following:

- Commodity Price Risk

As a means of mitigating exposure to commodity price risk volatility, the Company has entered into various derivative agreements. The use of derivative instruments is governed under formal policies and is subject to limits established by the Board of Directors. The Company's policy is to not use derivative financial instruments for speculative purposes.

Natural Gas – To partially mitigate the natural gas commodity price risk, the Company may enter into swaps, which fix the Canadian dollar AECO prices.

Crude Oil – The Company has partially mitigated its exposure to the WTI NYMEX price with fixed price swaps.

- Interest Rate Risk

Borrowings under bank credit facilities are market rate based (variable interest rates); thus, carrying values approximate fair values.

At the March 31, 2011 debt pricing levels, the increase or decrease in net earnings for each one percent change in interest rates would amount to $0.29 million (2010 - $0.21 million).

- Foreign Exchange Risk

As Zargon operates in North America, fluctuations in the exchange rate between the US/Canadian dollar can have a significant effect on the Company's reported results. A $0.01 change in the US to Canadian dollar exchange rate would have resulted in a $0.23 million (2010 - $0.28 million) increase or decrease in net earnings for the period ended March 31, 2011. In order to mitigate the Company's exposure to foreign exchange fluctuations, the Company may enter into foreign exchange derivative agreements.

- Credit Risk

Credit risk is the risk that the counterparty to a financial asset will default, resulting in the Company incurring a financial loss. This credit exposure is mitigated with credit practices that limit transactions according to counterparties' credit quality. A substantial portion of the Company's accounts receivable are with customers in the oil and natural gas industry and are subject to normal industry credit risks.

The maximum credit risk exposure associated with accounts receivable, accrued revenues and risk management assets is the total carrying value. The Company monitors these balances monthly to limit the risk associated with collection, of Zargon's accounts receivable at March 31, 2011, approximately 56 percent (December 31, 2010 – 54 percent) was owing from two companies and Zargon anticipates full collection.

The Company's allowance for doubtful accounts was $0.10 million as at March 31, 2011 and $0.10 million as at December 31, 2010. During 2010, the Company did not record any additional provisions for non-collectible accounts receivable.

When determining whether amounts that are past due are collectible, management assesses the credit worthiness and past payment history of the counterparty, as well as the nature of the past due amount. Zargon considers all material amounts greater than 90 days to be past due. As at March 31, 2011, $1.18 million of accounts receivable are past due, excluding amounts described above, all of which are considered to be collectable.

- Liquidity Risk

Liquidity risk is the risk the Company will encounter difficulties in meeting its financial liability obligations. The Company manages its liquidity risk through cash and debt management. See Note 6 for a more detailed discussion.

As at March 31, 2011, Zargon had available unused committed bank credit facilities of approximately $56.63 million compared to $63.46 million at December 31, 2010. The Company believes it has sufficient funding through the use of these facilities to meet foreseeable borrowing requirements.

The timing of cash outflows relating to financial liabilities are outlined in the table below:

($ thousands)	1 year	2–3 years	Total
Accounts payable and accrued liabilities	**36,888**	**–**	**36,888**
Cash dividends/distributions payable	**3,227**	**–**	**3,227**
Derivative liabilities	**21,379**	**6,269**	**27,648**
Long term debt	**–**	**121,893**	**121,893**

The Company is a party to certain financial instruments that have fixed the price of a portion of its oil and natural gas production and foreign exchange conversion rates. The Company enters into these contracts for risk management purposes only, in order to protect a portion of its future cash flow from the volatility of oil and natural gas commodity prices and foreign exchange rates. For financial risk management contracts, the Company considers these contracts to be effective on an economic basis but has decided not to designate these contracts as hedges for accounting purposes and, accordingly, any unrealized gains or losses are recorded in earnings based on the fair value (mark-to-market) of the contracts at each reporting period. The unrealized loss on the statement of earnings and comprehensive income for the first quarter of 2011 was $13.83 million and the unrealized loss for the same quarter in 2010 was $3.33 million.

As at March 31, 2011, the Company had the following outstanding commodity and electricity risk management contracts:

Commodity Financial Risk Management Contracts:

	Rate	Weighted Average Price	Range of Terms	Fair Market Value Liability ($ thousands)
Oil swaps	400 bbl/d	$77.40 US/bbl	Apr. 1/11 – Jun. 30/11	(1,060)
	300 bbl/d	$77.25 US/bbl	Apr. 1/11 – Sep. 30/11	(1,629)
	1,100 bbl/d	$83.33 US/bbl	Apr. 1/11 – Dec. 31/11	(7,235)
	600 bbl/d	$83.05 US/bbl	Apr. 1/11 – Jun. 30/12	(6,557)
	400 bbl/d	$85.54 US/bbl	Apr. 1/11 – Sep. 30/12	(4,638)
	200 bbl/d	$98.10 US/bbl	Jul. 1/11 – Jun. 30/12	(685)
	200 bbl/d	$83.50 US/bbl	Jul. 1/11 – Aug. 31/12	(1,988)
	200 bbl/d	$87.65 US/bbl	Oct. 1/11 – Sep. 30/12	(1,378)
	600 bbl/d	$94.78 US/bbl	Jan. 1/12 – Dec. 31/12	(2,458)
Total Fair Market Value, Commodity Price Financial Contracts				**(27,628)**

Oil swaps are settled against the NYMEX WTI pricing index.

Electricity Financial Risk Management Contracts:

	Rate	Weighted Average Price	Range of Terms	Fair Market Value Liability ($ thousands)
Electricity swaps	6 MWs/d	$79.33/MWh	Apr. 1/11 – Dec. 31/11	(20)
Total Fair Market Value, Electricity Financial Contracts				**(20)**

Electricity swaps are settled against the AESO pricing index.

Commodity price contracts are settled by way of physical delivery and are recognized as part of the normal revenue stream. Electricity contracts are settled by way of physical delivery and are recognized as part of the normal operating cost stream. These instruments have no book values recorded in the interim consolidated financial statements.

Commodity Price Sensitivities

The following table summarizes the sensitivity of the fair value of the Company’s risk management positions to fluctuations in commodity prices, with all other variables held constant. When assessing the potential impact of these commodity price changes, the Company believes 10 percent volatility is a reasonable long term measure.

Fluctuations of 10 percent in commodity prices could have resulted in unrealized gains or losses on risk management contracts impacting net earnings as follows:

	Three Months Ended March 31,	
($ thousands)	**2011**	2010
Crude oil price	**13,975**	9,845

6. CAPITAL DISCLOSURES

The Company's capital structure is comprised of shareholders' equity plus long term debt. The Company's objectives when managing its capital structure are to:

a) Maintain financial flexibility so as to preserve Zargon's access to capital markets and its ability to meet its financial obligations; and

b) Finance internally generated growth as well as acquisitions.

The Company monitors its capital structure and short term financing requirements using a non-GAAP financial metric, which is the ratio of debt net of working capital ("net debt") to funds flow from operating activities. Net Debt, as used by Zargon, is calculated as bank debt and any working capital deficit excluding the current portion of derivative financial assets and liabilities. Funds flow from operating activities represent net earnings/losses and asset retirement expenditures except for non-cash items. The metric is used to steward the Company's overall debt position as a measure of the Company's overall financial strength and is calculated as follows:

($ thousands, except ratio)	**March 31, 2011**	December 31, 2010
Net debt	**135,131**	124,392
Annualized funds flow from operating activities	**61,709**	72,932
Net debt to funds flow from operating activities ratio	**2.19**	1.71

As at March 31, 2011, Zargon's net debt to funds flow from operating activities ratio was 2.19, an increase from 1.71 at December 31, 2010, primarily due to an increased field capital program. On June 29, 2010, Zargon amended and renewed its syndicated committed credit facilities of $180 million. The next renewal date is June 28, 2011. These facilities continue to be available for general corporate purposes and the potential acquisition of oil and natural gas properties. The Company converted to a corporation from its previous trust structure on December 31, 2010. Zargon's current syndicated credit facility was amended and restated effective January 1, 2011 to reflect the corporate conversion.

To manage its capital structure, the Company may adjust capital spending, adjust dividends paid to shareholders, issue new shares, issue new debt or repay existing debt.

The Company's capital management objectives, evaluation measures, definitions and targets have remained unchanged over the periods presented. Zargon is subject to certain financial covenants in its credit facility agreements and is in compliance with all financial covenants.

Zargon reviews its compliance with its bank debt covenants on a quarterly basis and has no violations as at March 31, 2011.

7. BUSINESS COMBINATIONS

On September 9, 2010, the Company acquired all of the issued and outstanding shares of Oakmont Energy Ltd ("Oakmont") for total consideration of $5.95 million. Consideration consisted of the issuance of 335,574 Zargon common shares valued at $17.72 per share. The Company acquired Oakmont for its oil exploitation opportunities along with its complementary properties in our Alberta Plains South core area.

These consolidated financial statements incorporate the results of operations of the acquired Oakmont properties from September 9, 2010. For the period September 9, 2010 to December 31, 2010, Zargon recorded revenue from oil, natural gas and natural gas liquids of $0.91 million in respect of the acquired assets. Had the acquisition occurred on January 1, 2010, for the 12 months ended December 31, 2010, Zargon estimates that its pro forma revenue would have been approximately $3.84 million. On January 1, 2011, Oakmont was amalgamated into Zargon.

The preliminary purchase price allocation is as follows:

($ thousands)	
Identifiable assets acquired and liabilities assumed:	
Property, plant and equipment	11,953
Intangible exploration and evaluation assets	450
Trade and other receivables	584
Long term debt	(3,423)
Asset retirement obligations	(2,991)
Deferred tax liabilities	(56)
Trade and other payable	(571)
Total	5,946

($ thousands)	
Consideration paid:	
Common shares issued	5,946

Acquisition costs for the transaction of $0.13 million were included in Transaction Costs on the consolidated statements of earnings and comprehensive income for the year ended December 31, 2010.

8. OIL AND NATURAL GAS REVENUE

($ thousands)	**March 31, 2011**	March 31, 2010
Oil and natural gas sales	**46,941**	48,456
Less: royalties	**(7,570)**	(8,964)
Revenue, net of royalties	**39,371**	39,492

9. CHANGE IN NON-CASH FLOW INFORMATION

The net change in working capital is comprised of:

($ thousands)	**March 31, 2011**	March 31, 2010
Source/(use) of cash:		
Trade and other receivables	**(1,898)**	195
Deposit and prepaid expenses	**95**	395
Accounts payable and accrued liabilities	**2,707**	(918)
Cash dividends/distributions payable	**3,227**	45
Provisions	**1,270**	–
Foreign exchange and other	**(31)**	(112)
	5,370	(395)
Related to operating activities	**8,257**	(1,239)
Relating to investing activities	**(2,364)**	(32)
Related to financing activities	**(523)**	876
	5,370	(395)

10. SUPPLEMENTAL CASH FLOW INFORMATION

($ thousands)	**March 31 ,2011**	March 31, 2010
Cash interest paid	**1,564**	754
Cash taxes paid	**21**	2,020

11. PROPERTY, PLANT AND EQUIPMENT

	Three Months Ended	Twelve Months Ended
($ thousands)	**March 31, 2011**	December 31, 2010
Developed and Producing Assets:		
Cost, beginning of year	**461,264**	400,119
Accumulated depletion and depreciation, beginning of year	**(49,145)**	–
Net carrying amount, beginning of year	**412,119**	400,119
Net Additions	**20,132**	71,579
Additions from business combinations	**–**	11,953
Assets transferred from intangible exploration	**67**	215
Impairment loss	**–**	(22,867)
Exchange differences	**(663)**	329
Depletion and depreciation	**(12,775)**	(49,209)
Net carrying amount, end of period	**418,880**	412,119
Cost, end of year	**480,744**	461,264
Accumulated depletion and depreciation, end of period	**(61,864)**	(49,145)
Net carrying amount, end of period	**418,880**	412,119

(a) Impairment charge*:*

The depletion, depreciation and impairment of property, plant and equipment, and any eventual reversal thereof, are recognized in depletion and depreciation and impairment loss in the income statement (see also Note 13).

(b) Security:

At March 31, 2011 and 2010 a $300 million demand debenture on assets of the Company has been provided as security for the Company's syndicated committed credit facilities.

(c) Contingencies:

Although the Company believes that it has title to its oil and natural gas properties, it cannot control or completely protect itself against the risk of title disputes or challenges.

12. INTANGIBLE EXPLORATION AND EVALUATION ASSETS AND GOODWILL

($ thousands)	Goodwill	E&E assets	Total
Cost:			
Balance at January 1, 2010	2,969	24,368	27,337
Acquisitions	–	–	–
Net additions	–	3,555	3,555
Transfers to property, plant and equipment	–	(215)	(215)
Balance at December 31, 2010	**2,969**	**27,708**	**30,677**
Acquisitions	**–**	**–**	**–**
Net additions	**–**	**(81)**	**(81)**
Transfers to property, plant and equipment	**–**	**(67)**	**(67)**
Balance at March 31, 2011	**2,969**	**27,560**	**30,529**

Exploration and evaluation ("E&E") assets consist of the Company's exploration projects which are pending the determination of proved or probable reserves. Additions represent the Company's share of costs incurred on E&E assets during the period.

13. IMPAIRMENT LOSS

During the year ended December 31, 2010, due to low natural gas prices and as reflected in the forward strip with respect to the Alberta producing region, the Company tested its CGUs for impairment. The E&E assets associated with these CGUs were not included in this impairment test. Four of the Company's 10 CGUs were found to have impairment.

The recoverable amount of the CGUs was estimated based on its fair value less costs to sell. The estimate of fair value less costs to sell was determined using an after-tax discount rate of 10 percent and forecasted cash flows. The forecasted cash flows are prepared over the estimated life of the reserves in the CGUs. The prices used to estimate the fair value less cost to sell are those used by independent industry reserve engineers.

Based on the assessment in 2010, the carrying amount of the four CGUs was determined to be $22.87 million lower than its recoverable amount, and an impairment loss was recognized. In 2011, the Company did not reverse any impairment.

The impairment loss and its subsequent reversal were allocated *pro rata* to the individual assets constituting the CGUs as follows:

($ thousands)	Original carrying amount	Impairment loss in 2010	Reversal in 2011
Property, plant and equipment, net	**434,986**	**22,867**	**–**

The above estimates are particularly sensitive in the following areas:

- A one percent increase in the discount rate used would have increased the impairment loss by $5.44 million.
- A 10 percent decrease in future planned revenue would have increased the impairment loss by $13.68 million.

14. LONG TERM DEBT

On June 29, 2010, Zargon amended and renewed its syndicated committed credit facilities, the result of which was the maintaining of the available facilities and borrowing base of $180 million. These facilities consist of a $170 million tranche available to the Canadian borrower and a US $8 million tranche available to the US borrower. A $300 million demand debenture on the assets of the Company has been provided as security for these facilities. The facilities are fully revolving for a 364 day period with the provision for an annual extension at the option of the lenders and upon notice from Zargon's management. The next renewal date is June 28, 2011. Should the facilities not be renewed, they convert to one year non-revolving term facilities at the end of the revolving 364 day period. Repayment would not be required until the end of the non-revolving term, and, as such, these facilities have been classified as long term debt.

Interest rates fluctuate under the syndicated facilities with Canadian prime, US prime and US base rates plus an applicable margin between 100 basis points and 250 basis points as well as with Canadian banker's acceptance and LIBOR rates plus an applicable margin between 250 basis points and 400 basis points. At March 31, 2011, $121.89 million (December 31, 2010 - $115.29 million) had been drawn on the syndicated committed credit facilities with any unused amounts subject to standby fees. In the normal course of operations Zargon enters into various letters of credit. At March 31, 2011, the approximate value of outstanding letters of credit totalled $1.48 million (December 31, 2010 - $1.25 million). The letters of credit reduce the amount of Zargon's available credit facilities to $56.63 million at March 31, 2011 (December 31, 2010 - $63.46 million).

Zargon reviews its compliance with its bank debt covenants on a quarterly basis and has no violations as at March 31, 2011. Zargon converted to a corporation from its previous trust structure on December 31, 2010 and had to ensure that all legal and regulatory requirements were satisfied. Zargon's current syndicated credit facility was amended and restated effective January 1, 2011 to reflect the corporate conversion.

15. SHARE CAPITAL

Pursuant to the Arrangement, 23.93 million shares of the Company were issued in exchange for all of the outstanding trust units of the Trust on a one-for-one basis and 3.12 million shares of the Company were issued in exchange for all of the outstanding exchangeable shares based on an exchange ratio of 1.84716 at the time of conversion. Pursuant to the Arrangement, the shareholders' capital was reduced by the deficit of the Trust as of December 31, 2010 of $71.34 million.

The Company is authorized to issue an unlimited number of voting common shares and 10,000,000 preferred shares.

Zargon has a Dividend Reinvestment Plan ("DRIP") in place in conjunction with the Company's transfer agent to provide the option for shareholders to reinvest cash dividends into common shares issued from treasury at a five percent discount to the prevailing market price.

Common Shares

	March 31, 2011	
(thousands)	**Number of Shares**	**Amount ($)**
Balance, beginning of period	**27,046**	**201,091**
Share options exercised for cash	**154**	**2,821**
Share-based compensation recognized on exercise of share options	**–**	**608**
Issued pursuant to the Dividend Reinvestment Plan	**81**	**1,751**
Balance, end of period	**27,281**	**206,271**

Trust Units

	December 31, 2010	
(thousands)	Number of Units	Amount ($)
Balance, as at January 1, 2010	23,097	188,840
Unit rights exercised for cash	149	2,359
Unit-based compensation recognized on exercise of unit rights	–	482
Issued on corporate acquisitions [Note 7]	336	5,946
Dissolution of US subsidiary	–	149
Issued on redemption of exchangeable shares	162	3,182
Issued pursuant to the Distribution Reinvestment Plan	184	3,409
Exchanged on conversion to a corporation	(23,928)	(204,367)
Balance, as at December 31, 2010	–	–

Common Shares

(thousands)	December 31, 2010 Number of Units	Amount ($)
Balance, as at January 1, 2010	–	–
Issuance of common shares for trust units pursuant to corporate conversion	23,928	204,367
Issuance of common shares for exchangeable shares pursuant to corporate conversion	3,118	68,059
Reduction in shareholders' capital for deficit amounts [Notes 1 and 25(n)]	–	(71,335)
Balance, as at December 31, 2010	27,046	201,091

16. SHARE-BASED PAYMENTS

Prior to conversion to a corporation on December 31, 2010, Zargon's share-based payments were accounted for as liability instruments. IFRS 2 *Share-based Payment* applies only to equity instruments or awards based on the value of equity instruments whereas Zargon's trust units were only classified as equity for the purposes of the puttables amendment under IAS 32 *Financial Instruments: Presentation*. However, the unit-based compensation was accounted for as a liability and measured at fair value. On December 31, 2010, the conversion from an income trust into a corporation was completed and these payments were reclassified from liabilities to contributed surplus at their current fair value. Going forward, the Company's share-based payments are classified and accounted for as equity-settled share-based payments.

Share Award Plan

On December 15, 2010, a new share-based compensation plan (the "Share Award Plan") was approved and was effective January 1, 2011. Under the Share Award Plan, directors, officers, employees and other service providers (the "grantees") are granted the right to receive a defined number of shares in the future, which increases commensurately with each dividend declared by the Company after the grant date. The grantees will receive equity compensation in relation to the value of a specified number of underlying Share Awards. The awards vest equally over four years and expire five years after grant date. Holders may choose to exercise upon vesting or at any time thereafter, with forfeiture of any shares not exercised by the expiry date. Upon vesting, the grantees are eligible to receive a share award based on the fair value of the underlying Share Award's plus all dividends accrued since the grant date.

The following table summarizes information about the Company's share awards under the Share Award Plan:

	March 31, 2011 Number of Share Awards (thousands)
Outstanding at beginning of period	**–**
Share awards granted	**131**
Share awards forfeited	**(2)**
Outstanding at end of period	**129**

Common Share Rights Incentive Plans

In conjunction with the corporation conversion, Zargon's two original Trust Unit Rights Incentive Plans were amended and restated as Common Shares Rights Incentive Plans. Under these plans, directors, officers, employees and other service providers of the Company possess rights to acquire common shares at their option of either the original exercise price or a "modified price" as calculated per the provisions of the relevant plan. The Common Share Rights Incentive Plan (2007) (the "Old Plan") provides for a modified price based on the increment of the amount by which monthly dividends exceed a monthly return of 0.833 percent of the Company's recorded net book value of oil and natural gas properties (as defined in the Old Plan). Under the Common Share Rights Incentive Plan (2009) (the "New Plan"), if the monthly dividend exceeds the monthly return of 0.833 percent of the Company's recorded net book value of oil and natural gas properties (as defined under the New Plan), the entire amount (not the increment) of the dividend is deducted from the original grant price. Options granted under either Plan generally vest equally over a three-year period and expire approximately five years from the grant date. Zargon uses a fair value methodology to value the option grants.

The following table summarizes information about the Company's share options under the Old Plan:

	March 31, 2011	
	Number of Share Options (thousands)	**Weighted Average Exercise Price Initial and Modified ($/share)**
Outstanding at beginning of period	**738**	**25.61 / 23.10**
Share options exercised	**(98)**	**20.94**
Share options expired	**(41)**	**29.93**
Share options forfeited	**–**	**–**
Outstanding at end of period	**599**	**25.64 / 23.23**

The following table summarizes information about the Company's share options under the New Plan:

	March 31, 2011	
	Number of Share Options (thousands)	**Weighted Average Exercise Price Initial and Modified ($/share)**
Outstanding at beginning of period	**708**	**18.03 / 15.64**
Share options exercised	**(57)**	**13.49**
Share options forfeited	**(4)**	**18.85**
Outstanding at end of period	**647**	**18.13 / 15.37**

Share-based Payment Compensation

The weighted average assumptions used for share awards granted in 2011 include a volatility factor of expected market price of 30.90 percent, a risk-free interest rate of 2.23 percent and an expected life of the common shares of four years. The fair value of the share awards granted under the Share Award Plan in the year was calculated at $19.21 per share award. These share awards for the three months ended March 31, 2011, together with the continued vesting of options granted in prior years, resulted in share-based payment compensation expense in 2011 of $0.58 million (2010 – $0.45 million).

Compensation expense associated with awards/options granted under each Plan is recognized in earnings over the vesting period of the Plan with a corresponding increase in contributed surplus. The exercise of awards/options is recorded as an increase in common shares with a corresponding reduction in contributed surplus.

A forfeiture rate of nine percent (2010 – nine percent) is used when recording share-based payment compensation. This estimate is adjusted to the actual forfeiture rate.

17. EXCHANGEABLE SHARES

In connection with the corporation conversion (see Note 1), Zargon issued 3,117,638 common shares in exchange for the remaining 1,687,801 exchangeable shares based on the exchange ratio of 1.84716. This transaction was accounted for as an acquisition of the non-controlling interest at fair value. The fair value of the common shares issued in consideration for the non-controlling interest represented by the exchangeable shares was $68.06 million.

The following table summarizes the changes in the outstanding exchangeable share balance:

(thousands, except exchange ratio)	Number of Shares	Amount ($)
Balance, as at January 1, 2010	1,784	56,211
Exchanged for trust units	(96)	(1,929)
Exchanged for common shares pursuant to the corporate conversion [Note 1]	(1,688)	(54,282)
Balance, as at December 31, 2010	–	–

18. WEIGHTED AVERAGE NUMBER OF TOTAL SHARES

(thousands of shares)	**March 31 2011**	March 31 2010
Weighted average number of common shares – basic	**27,109**	23,184
Weighted average number of common shares – diluted	**27,338**	26,092

Basic per share amounts are calculated using the weighted average number of shares outstanding during the period. Diluted per share amounts are calculated using the treasury stock method to determine the dilutive effect of share-based compensation. Due to the fact that at the time of exercise, the rights holder has the option of exercising at the original grant price or a modified price as calculated under the Plan, the prices used in the treasury stock calculation are the lower prices calculated under the Plan.

19. PROVISIONS

($ thousands)	Asset retirement obligations	Other	Total
Balance at January 1, 2010	80,620	–	80,620
Provisions made during the year	16,379	–	16,379
Foreign exchange and other	(115)	–	(115)
Provisions used during the year	(3,556)	–	(3,556)
Accretion	3,067	–	3,067
Balance at December 31, 2010	96,395	–	96,395
Non-current	96,395	–	96,395

($ thousands)	Asset retirement obligations	Other	Total
Balance at January 1, 2011	**96,395**	**–**	**96,395**
Provisions made during the year	**106**	**1,270**	**1,376**
Foreign exchange and other	**(45)**	**–**	**(45)**
Provisions used during the year	**(655)**	**–**	**(655)**
Accretion	**802**	**–**	**802**
Balance at March 31, 2011	**96,603**	**1,270**	**97,873**
Non-current	**96,603**	**1,270**	**97,873**

Asset retirement obligations:

The Company's future asset retirement obligation was estimated by management based on Zargon's net working interest in all wells and facilities, estimated costs to reclaim and abandon wells and facilities and the estimated timing of the costs to be incurred in future periods. Zargon has estimated the net present value of its total asset retirement obligations to be $96.60 million as at March 31, 2011 (2010 – $96.40 million). These payments are expected to be made over the next 40 years with the majority of the costs being incurred after 2019. Commencing January 1, 2010, the asset retirement obligations is calculated using a discount factor of 3.5 percent being the risk free rate related to the liability and based on the Government of Canada long term bond rate. An inflation rate of two percent used in the calculation of the present value of the asset retirement obligation remains unchanged.

20. CONTINGENCIES AND COMMITMENTS

In the normal course of operations, Zargon executes agreements that provide for indemnification and guarantees to counterparties in transactions such as the sale of assets and operating leases.

These indemnifications and guarantees may require compensation to counterparties for costs and losses incurred as a result of various events, including breaches of representations and warranties, loss of or damages to property, environmental liabilities or as a result of litigation that may be suffered by counterparties.

Certain indemnifications can extend for an unlimited period and generally do not provide for any limit on the maximum potential amount. The nature of substantially all of the indemnifications prevents the Company from making a reasonable estimate of the maximum potential amount that might be required to pay counterparties as the agreements do not specify a maximum amount, and the amounts depend on the outcome of future contingent events, the nature and likelihood of which cannot be determined at this time.

The Company indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their services to the Company to the extent permitted by law. The Company has acquired and maintains liability insurance for its directors and officers. The Company is party to various legal claims associated with the ordinary conduct of business. The Company does not anticipate that these claims will have a material impact on its financial position.

Zargon is subject to normal course income tax audits by Canadian and US taxation authorities. During the fourth quarter of 2010, the Canada Revenue Agency commenced a flow-through share audit of a predecessor company from a prior corporate acquisition. During the first quarter of 2011, Zargon recorded a $1.27 million provision which was comprised of a $0.92 million charge to current income tax expense and $0.35 million charge to interest expense for the related Part XII.6 tax, with respect to this ongoing income tax audit. At this time, Zargon is uncertain of the timing and final outcome of this matter.

21. SIGNIFICANT SUBSIDIARIES

The Company has the following significant wholly owned subsidiaries which are incorporated in Canada:

Zargon Energy Ltd.

Zargon Oil & Gas Partnership

Ashton Oil & Gas Ltd.

Additionally, the Company has the following significant wholly owned subsidiaries incorporated in the United States:

Zargon Acquisition Inc.

Zargon Oil (ND) Inc.

22. SEGMENTED INFORMATION

Zargon's entire operating activities are related to exploration, development and production of oil and natural gas in the geographic regions of Canada and the US.

	Three Months Ended March 31, 2011		
($ thousands)	**Canada**	**United States**	**Combined**
Petroleum and natural gas revenue, net of royalties	**36,577**	**2,794**	**39,371**
Earnings/(losses) before income taxes	**(12,715)**	**1,551**	**(11,164)**
Net capital expenditures	**20,144**	**222**	**20,366**

	Three Months Ended March 31, 2010		
($ thousands)	Canada	United States	Combined
Petroleum and natural gas revenue, net of royalties	36,321	3,171	39,492
Earnings before income taxes	992	2,010	3,002
Net capital expenditures	17,955	280	18,235

	March 31, 2011		
($ thousands)	**Canada**	**United States**	**Combined**
Property, plant and equipment	**391,208**	**27,672**	**418,880**
Intangible exploration and evaluation assets and goodwill	**29,862**	**667**	**30,529**
Total assets	**452,909**	**31,066**	**483,975**

	December 31, 2010		
($ thousands)	Canada	United States	Combined
Property, plant and equipment	383,539	28,580	412,119
Intangible exploration and evaluation assets and goodwill	30,009	668	30,677
Total assets	440,564	31,682	472,246

Reconciliation of operating profit to earnings/(loss) before income tax

	Three Months Ended March 31, 2011		
($ thousands)	**Canada**	**United States**	**Combined**
Segment profit	**(10,142)**	**1,586**	**(8,556)**
Net finance expense	**(2,573)**	**(35)**	**(2,608)**
Earnings/(loss) before income tax	**(12,715)**	**1,551**	**(11,164)**

	Three Months Ended March 31, 2010		
($ thousands)	Canada	United States	Combined
Segment profit	2,726	2,046	4,772
Net finance expense	(1,734)	(36)	(1,770)
Earnings before income tax	992	2,010	3,002

23. CASH DIVIDENDS

During the period, the Company declared dividends to the shareholders in the aggregate amount of $11.40 million (2010 – $12.55 million) in accordance with the following schedule:

2011 Dividends (1)	**Record Date**	**Dividend Date**	**Per Common Share**
January	January 31, 2011	February 15, 2011	$0.14
February	February 28, 2011	March 15, 2011	$0.14
March	March 31, 2011	April 15, 2011	$0.14

(1) The 2011 cash dividends include a non-cash equity issuance amount of $1.75 million for the Dividend Reinvestment Plan.

24. SUBSEQUENT EVENT

Subsequent to the end of the first quarter, on April 7, 2011, Zargon closed an offering of 1.725 million common shares on a bought deal basis at $22.60 per share for total gross proceeds of $38.99 million ($36.93 million net of issue costs). The proceeds will be used to pay down debt and to partially fund the oil-focused 2011 capital program.

25. RECONCILIATION OF BALANCE SHEET FROM CANADIAN GAAP TO IFRS

The effect of the Company's transition to IFRS, described in Note 2, is summarized in this note as follows:

(i) Transition elections

(ii) Reconciliation of equity and comprehensive income as previously reported under Canadian GAAP to IFRS

(iii) Adjustments to the statement of cash flows

(i) Transition elections

The Company has applied the following transition exceptions and exemptions to full retrospective application of IFRS:

	As described below
Full cost book value as deemed cost	(b)
Share-based payments	(g)
Currency translation adjustment	(h)
Business combinations	(i)
Borrowing costs	(k)

As at the date of transition to IFRS – January 1, 2010:

($ thousands)	Notes	Canadian GAAP	Effect of Transition to IFRS	IFRS
ASSETS				
Trade and other receivables		25,223	–	25,223
Prepaid expenses and deposits		2,013	–	2,013
Derivatives		4,289	–	4,289
Deferred tax assets	(a)	1,714	(1,714)	–
Total current assets		33,239	(1,714)	31,525
Long term deposit		1,845	–	1,845
Property, plant & equipment, net	(b) (c) (i)	425,964	(25,845)	400,119
Intangible exploration assets	(b)	–	24,368	24,368
Goodwill		2,969	–	2,969
Deferred tax assets	(a)	361	1,714	2,075
		464,378	(1,477)	462,901
LIABILITIES				
Trade and other payables		34,507	–	34,507
Cash distributions payable		4,157	–	4,157
Derivatives		6,032	–	6,032
Deferred tax liabilities	(a)	1,219	(1,219)	–
Exchangeable shares	(f)	–	56,211	56,211
Total current liabilities		45,915	54,992	100,907
Long term debt		76,580	–	76,580
Derivatives		1,270	–	1,270
Unit-based compensation liability	(g)	–	6,111	6,111
Provisions	(j)	35,468	45,152	80,620
Deferred tax liabilities	(e)	30,327	(14,055)	16,272
		189,560	92,200	281,760
EQUITY				
Unitholders' capital		188,840	–	188,840
Non-controlling interest – exchangeable shares	(f)	26,477	(26,477)	–
Contributed surplus	(g)	5,471	(5,471)	–
Retained earnings	(q)	54,030	(61,729)	(7,699)
		274,818	(93,677)	181,141
		464,378	(1,477)	462,901

See accompanying explanatory notes.

As at the quarter ended – March 31, 2010:

($ thousands)	Notes	Canadian GAAP	Effect of Transition to IFRS	IFRS
ASSETS				
Trade and other receivables		25,028	–	25,028
Prepaid expenses and deposits		1,618	–	1,618
Derivatives		1,921	–	1,921
Deferred tax assets	(a)	1,761	(1,761)	–
Total current assets		30,328	(1,761)	28,567
Long term deposit		1,845	–	1,845
Derivatives	(b) (c) (i)	18	–	18
Property, plant & equipment, net	(b)	430,592	(24,322)	406,270
Intangible exploration assets		–	25,044	25,044
Goodwill	(a)	2,969	–	2,969
Deferred tax assets		468	1,761	2,229
		466,220	722	466,942
LIABILITIES				
Trade and other payables		33,589	–	33,589
Cash distributions payable		4,202	–	4,202
Derivatives	(a)	6,540	–	6,540
Deferred tax liabilities	(f)	517	(517)	–
Exchangeable shares		–	57,494	57,494
Total current liabilities		44,848	56,977	101,825
Long term debt		84,229	–	84,229
Derivatives	(g)	1,739	–	1,739
Unit-based compensation liability	(j)	–	6,243	6,243
Provisions	(e)	35,818	45,837	81,655
Deferred tax liabilities		28,255	(14,217)	14,038
		194,889	94,840	289,729
EQUITY				
Unitholders' capital	(f)	193,740	–	193,740
Non-controlling interest – exchangeable shares	(h)	25,432	(25,432)	–
Currency translation adjustment	(g)	–	(627)	(627)
Contributed surplus		5,525	(5,525)	–
Retained earnings		46,634	(62,534)	(15,900)
		271,331	(94,118)	177,213
		466,220	722	466,942

See accompanying explanatory notes.

At the end of the last reporting year under Canadian GAAP – December 31, 2010:

($ thousands)	Notes	Canadian GAAP	Effect of Transition to IFRS	IFRS
ASSETS				
Trade and other receivables		22,883	–	22,883
Prepaid expenses and deposits		2,191	–	2,191
Deferred tax assets	(a)	2,894	(2,894)	–
Total current assets		27,968	(2,894)	25,074
Long term deposit		653	–	653
Property, plant & equipment, net	(b) (c) (i) (m)	439,228	(27,109)	412,119
Intangible exploration assets	(b)	–	27,708	27,708
Goodwill		2,969	–	2,969
Deferred tax assets	(a)	830	2,893	3,723
		471,648	598	472,246
LIABILITIES				
Trade and other payables		30,431	–	30,431
Cash dividend/distribution payable		3,750	–	3,750
Derivatives		10,737	–	10,737
Total current liabilities		44,918	–	44,918
Long term debt		115,285	–	115,285
Derivatives		3,080	–	3,080
Provisions	(j)	42,979	53,416	96,395
Deferred tax liabilities	(e)	18,190	(13,320)	4,870
		224,452	40,096	264,548
EQUITY				
Shareholders' capital		240,805	(39,714)	201,091
Currency translation adjustment	(h)	–	(1,208)	(1,208)
Contributed surplus	(g)	6,391	1,424	7,815
Retained earnings	(n)	–	–	–
		247,196	(39,498)	207,698
		471,648	598	472,246

See accompanying explanatory notes.

Reconciliation of consolidated statement of earnings and comprehensive income for the quarter ended March 31, 2010:

($ thousands)	Notes	Canadian GAAP	Effect of Transition to IFRS	IFRS
REVENUE				
Oil and natural gas revenue	(l)	48,456	(8,964)	39,492
Unrealized risk management loss	(o)	(3,327)	3,327	–
Realized risk management loss	(o)	1,180	(1,180)	–
Royalties	(l)	(8,964)	8,964	–
		37,345	2,147	39,492
EXPENSES				
(Gain)/loss on unrealized derivatives	(o)	–	3,327	3,327
(Gain)/loss on realized derivatives	(o)	–	(1,180)	(1,180)
Production and operating expenses		11,574	–	11,574
Transportation expenses		274	–	274
Exploration and evaluation expenses	(b)	–	505	505
General and administrative expenses		3,577	–	3,577
Unrealized foreign exchange gain	(h)	(26)	26	–
Exchangeable shares revaluation	(f)	–	4,081	4,081
Share-based compensation	(g)	371	78	449
Depletion, depreciation and amortization	(c)	16,399	(4,286)	12,113
		32,169	2,551	34,720
FINANCE EXPENSES				
Interest and financing charges		1,070	–	1,070
Accretion of asset retirement obligations	(j)	781	(81)	700
		1,851	(81)	1,770
EARNINGS/(LOSS) BEFORE INCOME TAXES		3,325	(323)	3,002
INCOME TAXES				
Current		748	–	748
Deferred tax recovery	(e)	(3,227)	1,130	(2,097)
		(2,479)	1,130	(1,349)
NET EARNINGS/(LOSSES) FOR THE PERIOD		5,804	(1,453)	4,351
LESS NET EARNINGS ATTRIBUTED TO NON-CONTROLLING INTEREST	(f)	649	(649)	–
NET EARNINGS ATTRIBUTED TO ZARGON		5,155	(804)	4,351
Other comprehensive income				
Currency translation adjustment (net of $0.18 million of tax)	(h)	–	(449)	(449)
Other comprehensive income for the period		–	(449)	(449)
Total comprehensive income for the period		5,155	(1,253)	3,902

See accompanying explanatory notes.

Reconciliation of consolidated statement of earnings and comprehensive income for the year ended December 31, 2010:

($ thousands)	Notes	Canadian GAAP	Effect of Transition to IFRS	IFRS
REVENUE				
Oil and natural gas revenue	(l)	179,472	(31,937)	147,535
Unrealized risk management loss	(o)	(10,804)	10,804	–
Realized risk management loss	(o)	471	(471)	–
Royalties	(l)	(31,937)	31,937	–
		137,202	10,333	147,535
EXPENSES				
(Gain)/loss on unrealized derivatives	(o)	–	10,804	10,804
(Gain)/loss on realized derivatives	(o)	–	(471)	(471)
Production and operating expenses		46,016	–	46,016
Transportation expenses		1,169	–	1,169
Exploration and evaluation expenses	(b)	–	2,813	2,813
General and administrative expenses		15,240	–	15,240
Transaction costs		1,258	–	1,258
Gain on disposal of properties	(m)	–	(3,252)	(3,252)
Unrealized foreign exchange gain	(h)	(42)	42	–
Exchangeable shares revaluation	(f)	–	15,029	15,029
Loss on impairment	(b)	–	22,867	22,867
Share-based compensation	(g)	1,446	784	2,230
Depletion, depreciation and amortization	(c)	66,415	(17,206)	49,209
		131,502	31,410	162,912
FINANCE EXPENSES				
Interest and financing charges		4,889	–	4,889
Accretion of asset retirement obligations	(j)	3,522	(455)	3,067
		8,411	(455)	7,956
EARNINGS/(LOSS) BEFORE INCOME TAXES		(2,711)	(20,622)	(23,333)
INCOME TAXES				
Current		2,145	–	2,145
Deferred tax recovery	(e)	(14,875)	2,275	(12,600)
		(12,730)	2,275	(10,455)
NET EARNINGS/(LOSSES) FOR THE PERIOD		10,019	(22,897)	(12,878)
LESS NET EARNINGS ATTRIBUTED TO NON-CONTROLLING INTEREST	(f)	1,097	(1,097)	–
NET EARNINGS ATTRIBUTED TO ZARGON		8,922	(21,800)	(12,878)
Other comprehensive income				
Currency translation adjustment (net of $0.34 million of tax)	(h)	–	(864)	(864)
Other comprehensive income for the period		–	(864)	(864)
Total comprehensive income for the period		8,922	(22,664)	(13,742)

See accompanying explanatory notes.

Explanatory notes

(a) Under IFRS all deferred taxes must be classified as non-current. Under Canadian GAAP, deferred taxes relating to current assets or current liabilities must be classified as current. Accordingly, current deferred tax assets reported under Canadian GAAP of $1.71 million and current deferred tax liabilities of $1.22 million at January 1, 2010 ($1.76 million and $0.52 million, respectively, at March 31, 2010 and $2.89 million at December 31,2010) have been re-classified as non-current under IFRS.

(b) The Company elected under IFRS 1 to deem the Canadian GAAP carrying value of its oil and gas assets accounted for under the full cost method as at January 1, 2010 as their deemed cost under IFRS as at that date. As such the Canadian GAAP full cost pool was reallocated upon transition to IFRS and the 2010 comparatives were restated to reflect the new IFRS accounting policies as follows:

i. In accordance with IAS 16, IAS 38 and IFRS 6 on January 1, 2010 the Company reallocated costs of $24.37 million relating to unproved properties from property, plant and equipment to exploration and evaluation assets.

ii. Under Canadian GAAP all costs incurred prior to having obtained licence rights and lease expiries were included within property, plant and equipment. Under IFRS, such expenditures are expensed as incurred. There was no impact on adoption of IFRS due to the full cost as deemed cost exemption. However, the comparative 2010 balances were restated at March 31, 2010 and December 31, 2010 resulting in a reduction in property, plant and equipment and retained earnings of $0.51 million and $2.81 million respectively, and an increase in exploration and evaluation expenses for the three months and for the year of the same amounts.

iii. The remaining full cost pool was allocated to the developed and producing assets pro rata using reserve values.

iv. Under IFRS, impairment tests must be performed at a more granular level than what was required under Canadian GAAP. The Canadian GAAP “ceiling test” incorporated a 2-step approach for testing impairment, while IFRS uses a 1-step approach. Under Canadian GAAP, a discounted cash flow analysis was not required if the undiscounted cash flows from proved reserves exceeded the carrying amount (step 1). If the carrying amount exceeded the undiscounted future cash flows, then a prescribed discounted cash flow test was performed (step 2). Under IFRS, impairment testing is based on discounted cash flows and is calculated at the CGU level. Impairment tests are required to be performed at the transition date, and as at January 1, 2010 no impairment was identified. Additional impairment tests were performed as at March 31, 2010 and December 31, 2010. The outcome of these impairment tests are as follows: At March 31, 2010 an impairment test was performed and it was determined that there was no impairment. At December 31, 2010 an impairment test was performed and four of the Company’s 10 CGUs were found to have impairment. For further details please refer to Note 13.

(c) Upon transition to IFRS, the Company adopted a policy of depleting oil and natural gas interests on a “units of production” basis over proved plus probable reserves on a field by field basis. The depletion policy under Canadian GAAP was units of production over proved reserves on a country by country basis. At March 31, 2010 this resulted in decreases in property, plant and equipment of, retained earnings and depletion expense of $4.29 million. The December 31, 2010 effect was a decrease in property, plant and equipment, retained earnings and depletion expense of $17.21 million.

(d) Under IFRS, impairment losses previously recorded are reversed if there has been an improvement in the estimates used to determine recoverable amount, except for goodwill. The reversal of impairment losses was not permitted under Canadian GAAP. This had no impact on adoption to IFRS at January 1, 2010 due to the full cost as deemed cost exemption. There have been no impairment loss reversals subsequent to transition date.

(e) Under IFRS, the Company’s asset retirement obligation increased by $43.87 million at January 1, 2010 (please refer to explanatory Note (j) for further details) which resulted in a reduction in the deferred tax liability under IFRS.

As Zargon Energy Trust was a flow-through entity whose taxable income passed through to unitholders, under IFRS the temporary tax differences prior to the corporate conversion on December 31, 2010 must be tax affected at the top marginal personal tax rate in Canada. Under Canadian GAAP, the Trust’s temporary differences were tax affected at the statutory corporate tax rate. This difference resulted in a reduction in the deferred tax liability under IFRS, as the Trust was in a net tax asset position.

As a results of all measurement differences, including the two discussed above, the Company recorded a decrease in the deferred tax liability on the opening balance sheet of $15.27 million, by $14.73 million for the three months ended March 31, 2010 and $13.32 million for the year ended December 31, 2010.

(f) Under Canadian GAAP, exchangeable shares were accounted for as non-controlling interest ("NCI"), however under IFRS the exchangeable shares are accounted for as financial liabilities at amortized cost under (which is equivalent to fair value). As a result, Zargon's exchangeable shares will be measured at fair value at each reporting period and classified as a liability rather than as a NCI in equity under Canadian GAAP. Since the exchangeable shares were redeemed at the time of our corporate conversion on December 31, 2010, the 2010 exchangeable shares are classified as a current liability. The re-measurement to fair value resulted in an increase to exchangeable shares of $29.73 as at January 1, 2010. The Company recorded an increase in exchangeable shares by $4.08 million for the three months ended March 31, 2010 and $15.03 million for the year ended December 31, 2010, with the offsetting entries recorded to earnings under the line item "exchangeable shares revaluation".

(g) Prior to conversion to a corporation on December 31, 2010, Zargon's share-based payments were accounted for as liability instruments. IFRS 2 *Share Based Payments* applies only to common share equity instruments whereas Zargon's trust units were classified as equity under the puttables amendment under IAS 32 *Financial Instruments: Presentation*. The trust units are classified as equity as a result of the puttable amendment; however the unit-based payments were classified as cash-settled instruments and therefore were accounted for as liabilities ("unit-based compensation liability") and measured at fair value. On December 31, 2010, the conversion from an income trust into a corporation was completed and these payments were reclassified from liabilities to contributed surplus at their current fair value. The Company has elected to apply IFRS 2 *Share-based Payment* only for unvested options and unsettled liability awards outstanding for the post-conversion periods. Under IFRS the Company accrues the cost of employee stock options over the vesting period using the graded method of amortization rather than the straight-line method, which was the Company's policy under Canadian GAAP. This increased the unit-based compensation liability and reduced retained earnings at the date of transition by $0.64 million and increased share-based compensation expense by $0.08 million for the three months ended March 31, 2010 and $0.78 million for the year ended December 31, 2010.

(h) The Company has elected to reset the currency translation adjustment account, which includes gains and losses arising from the translation of foreign operations, to zero at the date of transition to IFRS, which reduced retained earnings by $1.48 million. A currency translation adjustment of $0.63 million was recognized for the three months ended March 31, 2010 and $1.21 million for the year ended December 31, 2010. Under IFRS amounts are initially recognized in a subsidiary's functional currency (the currency of the primary economic environment in which it operates) and are translated into the functional currency used for presentation of the consolidated financial statements (refer to Note 3(b) for more information). The assessment of the functional currency has resulted in transactions and balances for Zargon's US subsidiaries to be initially recognized in USD. Under Canadian GAAP, these subsidiaries were considered to be integrated and were translated with only monetary assets and liabilities retranslated using year end rates. This increased property, plant and equipment, evaluation and exploration assets by $6.19 million as at January 1, 2010. This increased property, plant and equipment, evaluation and exploration assets by $6.83 million and $0.10 million, respectively, for the three months ended March 31, 2010. This increased property, plant and equipment, evaluation and exploration assets by $6.93 million and $0.16 million, respectively, for the year ended December 31, 2010.

(i) The Company elected to apply IFRS 3 (revised) *Business Combinations* to business combinations prospectively from January 1, 2010. As such, Canadian GAAP balances relating to business combinations entered into before that date, including goodwill, have been carried forward without adjustment.

(j) As stated in Note (b), the Company has elected to utilize the full cost as deemed cost exemption, thereby requiring that the Company measure its asset retirement obligation as at the date of transition in accordance with IAS 37 and recognise the difference between Canadian GAAP and IFRS in retained earnings. As such the Company has re-measured the provision as at January 1, 2010 under IAS 37, estimated the amount to be recognized in retained earnings by discounting the liability to the date at which the liability first arose. This resulted in a decrease in retained earnings and increase in the asset retirement obligation of $45.15 million at January 1, 2010. This resulted in an increase in the asset retirement obligation and property, plant and equipment of $45.84 million for the three months ending March 31, 2010 and $53.42 million for the year ended December 31, 2010 primarily due to a change in the discount rate applied from a credit adjusted rate required by Canadian GAAP, to a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation as well as restatement of the entire obligation using the current period discount rate rather than only applying the current period discount rate to upward revisions in the future costs estimates as was required under Canadian GAAP.

(k) The Company will apply the transitional exemption relating to borrowing costs, whereby only borrowing costs incurred after transition date will be capitalized to qualifying assets, if any. There have been no qualifying assets subsequent to transition date.

(l) Under Canadian GAAP, royalties were presented separately from revenues, while revenue is presented net of royalties under IFRS. As a result, the Company reclassified royalties as a reduction of sales under IFRS of $8.96 million for the three month period ended March 31, 2010 and $31.94 million for the year ended December 31, 2010.

(m) Under Canadian GAAP, proceeds from dispositions of PP&E were deducted from the full cost pool without recognition of a gain or loss, unless the deduction resulted in a change to the depletion rate of 20 percent or greater, in which case a gain or loss was recorded. Under IFRS, gains or losses are recorded on dispositions and are recalculated as the difference between the proceeds and the net book value of the assets disposed. For the year ended December 31, 2010, the Company recognized a $3.25 million gain on disposals under IFRS (nil under Canadian GAAP).

(n) On December 31, 2010, Zargon Energy Trust completed the conversion from an income trust into a corporation, pursuant to a Plan of Arrangement (the "Arrangement"). Consistent with Canadian GAAP, under IFRS the shareholders' capital was reduced by the amount of the deficit on December 31, 2010 of $71.34 million compared to $31.47 million under Canadian GAAP. The increased amount under IFRS is mainly attributed to the $22.87 million impairment loss recognized and $15.03 million of exchangeable shares revaluation for the year ended December 31, 2010.

(o) Under Canadian GAAP, both realized and unrealized risk management gains and losses were classified under the Revenue section. Under IFRS, these accounts have been reclassified to the Expenses section and renamed as "derivatives".

(p) Adjustments to the statement of cash flows:

The transition from Canadian GAAP to IFRS had no significant impact on cash flows generated by the Company except that, under IFRS, the requirement is to only classify oil & natural gas costs as investing if they are capitalized. Any costs that are expensed under IFRS, such as pre-license costs and lease expiries (i.e. exploration and evaluation expenses), are classified as operating under IFRS.

(q) Adjustments to retained earnings:

Under IFRS 1 most changes to the January 1, 2010 opening balance sheet were applied retrospectively through retained earnings. This includes the changes to ARO, PP&E (foreign exchange), exchangeable shares, unit-based compensation liability and deferred taxes as described above. The cumulative effect of these changes, which is in excess of the opening balance of retained earnings and results in a revised opening deficit of $7.70 million, is summarized below:

($ thousands)	
Reduction due to increase in asset retirement obligations	(45,152)
Reduction due to revaluation of exchangeable shares	(29,734)
Reduction due to higher unit-based compensation	(640)
Reduction due to revaluation of FX on US subsidiary (PP&E)	(1,477)
Increase due to ARO increase and changes in the Trust's tax rate	15,274
Reduction in opening retained earnings	(61,729)

CORPORATE INFORMATION

BOARD OF DIRECTORS

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Calgary, Alberta

K. James Harrison (3) (4)
Chairman of the Board
Oakville, Ontario

Kyle D. Kitagawa (1) (2)
Calgary, Alberta

Margaret A. McKenzie (1) (3)
Calgary, Alberta

Geoffrey C. Merritt (2)
Calgary, Alberta

Jim Peplinski (2) (4)
Calgary, Alberta

J. Graham Weir (1) (2)
Calgary, Alberta

Grant A. Zawalsky (3) (4)
Calgary, Alberta

OFFICERS

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President and Chief Executive Officer

Charles L. Buckley
Vice President, Geosciences

Jason B. Dranchuk
Vice President, Finance and
Chief Financial Officer

Tracy L. Howard
Corporate Secretary

Brian G. Kergan
Vice President, Corporate Development

Kevin C.Y. Lee
Vice President, Alberta Plains North

Robert T. Moriyama
Vice President, Enhanced Recovery

Lorne D. Schwetz
Vice President, Land

Al D. Thorsen
Vice President, Operations

(1) Audit Committee
(2) Reserves Committee
(3) Governance and Nominating Committee
(4) Compensation Committee

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Toronto Stock Exchange

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Common Shares
Trading Symbol: ZAR

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