2011 Q2 FINANCIAL REPORT

Focused on exploitation

FINANCIAL & OPERATING HIGHLIGHTS

(unaudited)	Three Months Ended June 30, 2011	2010 (restated)	Percent Change	Six Months Ended June 30, 2011	2010 (restated)	Percent Change
Financial						
Income and Investments ($ millions)						
Petroleum and natural gas sales, before royalties	**48.47**	43.89	10	**95.41**	92.34	3
Funds flow from operating activities	**13.76**	18.24	(25)	**28.98**	40.22	(28)
Cash flows from operating activities	**13.06**	12.74	3	**36.54**	33.48	9
Cash dividends (net of Dividend Reinvestment Plan)	**10.47**	11.88	(12)	**20.12**	24.43	(18)
Net earnings	**12.67**	17.86	(29)	**3.56**	22.21	(84)
Net capital expenditures	**8.02**	34.37	(77)	**28.38**	52.61	(46)
Per Share, Diluted						
Funds flow from operating activities ($/share)	**0.47**	0.70	(33)	**1.03**	1.53	(33)
Cash flows from operating activities ($/share)	**0.45**	0.49	(8)	**1.29**	1.28	1
Net earnings ($/share)	**0.43**	0.68	(37)	**0.13**	0.85	(85)
Cash Dividends ($/common share)	**0.42**	0.54	(22)	**0.84**	1.08	(22)
Balance Sheet at Period End ($ millions)						
Property and equipment (D&P)				**414.97**	437.46	(5)
Exploration and evaluation assets (E&E)				**27.07**	26.54	2
Bank debt				**95.79**	114.12	(16)
Shareholders' equity				**232.57**	184.27	26
Total Common Shares Outstanding at Period End (millions)				**29.13**	26.33	11
Operating						
Average Daily Production						
Oil and liquids (bbl/d)	**5,034**	5,740	(12)	**5,461**	5,647	(3)
Natural gas (mmcf/d)	**21.91**	25.86	(15)	**21.91**	26.45	(17)
Equivalent (boe/d)	**8,686**	10,050	(14)	**9,113**	10,056	(9)
Equivalent per million common shares (boe/d)	**298**	382	(22)	**323**	382	(15)
Average Selling Price (before the impact of financial risk management contracts)						
Oil and liquids ($/bbl)	**89.55**	67.27	33	**81.90**	70.38	16
Natural gas ($/mcf)	**3.74**	3.72	1	**3.65**	4.26	(14)
Wells Drilled, Net	**2.1**	6.3	(67)	**9.6**	19.1	(50)
Undeveloped Land at Period End (thousand net acres)				**478**	521	(8)

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.

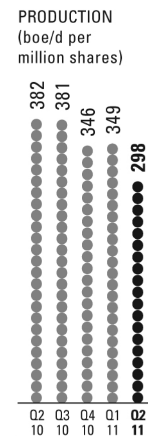
- Average daily production per million common shares, for 2010, is calculated using the weighted average number of units outstanding during the period plus the weighted average number of exchangeable shares outstanding for the period converted at the average exchange ratio for the period.

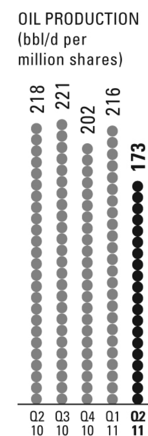
FINANCIAL & OPERATING HIGHLIGHTS

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

Highlights from the three months ended June 30, 2011 are noted below:

- Second quarter 2011 production averaged 8,686 barrels of oil equivalent per day, nine percent lower than the preceding quarter and 14 percent lower than the corresponding 2010 quarter. Severe wet weather conditions that restricted field access in the Williston Basin core area reduced oil and liquids average production to 5,034 barrels per day, which is a decrease of 15 percent from the previous quarter and 12 percent from the corresponding 2010 quarter.
- Funds flow from operating activities of $13.76 million ($0.47 per diluted share) were 10 percent lower than the $15.22 million ($0.56 per diluted share) recorded in the prior quarter, and 25 percent lower than the $18.24 million ($0.70 per diluted share) reported in second quarter 2010. The second quarter amount included reductions for $5.05 million of realized hedge losses, $0.94 million of prior period royalty adjustments and $0.74 million of asset retirement expenses.
- Three monthly cash dividends of $0.14 per common share were declared in the second quarter of 2011 for a total of $12.21 million ($10.47 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 76 percent of funds flow from operating activities.
- Exploration and development capital expenditures (excluding property acquisitions and dispositions) decreased 65 percent from the prior quarter to $7.73 million primarily due to flooded surface leases in the Williston Basin core area which delayed our drilling program.
- During the quarter, 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 were initially used to pay down debt and will subsequently be used to partially fund the 2011 capital program. Accordingly, debt net of working capital (excluding unrealized derivative assets/liabilities) decreased 24 percent from the prior quarter to $102.12 million at June 30, 2011.
- On June 28, 2011, Zargon amended and renewed its syndicated committed credit facilities of $180 million. These facilities are available for general corporate purposes and the acquisition of oil and natural gas properties.
- Subsequent to quarter end, Zargon completed the disposition of two Williston Basin properties producing a total of 260 barrels of oil per day for total cash compensation of approximately $24.5 million.





OIL AND LIQUIDS PRODUCTION (bbl/d)

Production (1)

Oil and liquids production averaged 5,034 barrels per day in the 2011 second quarter, a 15 percent decrease from the 5,893 barrels per day produced in the prior quarter, and was impacted by severe wet weather conditions in the Williston Basin core area, which resulted in the shut-in of approximately 760 barrels per day. Oil and liquids production represented 58 percent of total production based on a 6:1 equivalent basis. Natural gas production averaged 21.91 million cubic feet per day, a nominal decrease from the previous quarter and a 15 percent decrease from the corresponding period in 2010.

Early in the third quarter, as conditions within Zargon's operating areas began to dry out, field activities resumed and production that had been shut-in due to surface access conditions has largely been restored, resulting in early August production of over 8,700 barrels of oil equivalent per day comprised of approximately 5,150 barrels of oil per day and 21.3 million cubic feet per day of natural gas. The remaining 150 barrels of oil per day of shut-ins in the Williston Basin core area are anticipated to be returned to production by the end of August.

Drilling activity has commenced and, currently, Zargon has two rigs operating; one each in southeast Saskatchewan and eastern Alberta. For the second half of 2011, Zargon expects to drill 25 net wells, which includes eight net horizontal Mississippian oil wells in the Williston Basin core area and 17 net horizontal and vertical oil exploitation wells in the Alberta Plains core areas.

NATURAL GAS PRODUCTION (mmcf/d)

Capital Expenditures and Budgets (1)

Reflecting the flooded leases and road bans in the Williston Basin core area, Zargon's muted second quarter field capital program totalled $7.73 million, a 65 and 53 percent decrease from the respective 2011 first quarter and 2010 second quarter. During the quarter, Zargon drilled three gross wells that resulted in 2.1 net oil wells for a 100 percent success ratio. The drilling program included two Glauconite horizontal wells at Killam and one non-operated Viking horizontal well at Harmattan in the Alberta Plains North core area.

Subsequent to quarter end, Zargon disposed of its Williston Basin core area Antler and Manor properties for net proceeds of approximately $24.5 million. These properties were producing 260 barrels of oil per day. With this disposition, and assuming no further acquisitions or dispositions, Zargon's 2011 net capital program is now budgeted at $40 million with the $65 million field capital program being partially funded by net dispositions of $25 million. For further discussion regarding capital programs and current production guidance levels, please refer to our July 19, 2011 press release and our August 10, 2011 corporate presentation available on our web site at www.zargon.ca.

Further to the Williston Basin property dispositions, Zargon's debt net of working capital is currently less than $80 million and represents only 45 percent of Zargon's recently renewed $180 million syndicated loan facility. Furthermore, Zargon has entered into the following forward oil sale contracts as a risk management tool to assist in the funding of dividends and capital programs in the event of significant oil commodity price declines.

PRODUCTION (boe/d)

	Rate	Weighted Average Price	Range of Terms
Oil Swaps	2,750 bbl/d	$84.50 US/bbl	Jul. 1/11 – Dec. 31/11
	2,500 bbl/d	$89.91 US/bbl	Jan. 1/12 – Jun. 30/12
	1,667 bbl/d	$95.96 US/bbl	Jul. 1/12 – Dec. 31/12
	450 bbl/d	$101.89 US/bbl	Jan. 1/13 – Jun. 30/13

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

Management's discussion and analysis ("MD&A") is a review of Zargon Oil & Gas Ltd.'s 2011 second quarter financial results and should be read in conjunction with the unaudited interim consolidated financial statements and related notes for the three and six months ended June 30, 2011, the audited consolidated financial statements and related notes for the year ended December 31, 2010 and the unaudited interim consolidated financial statements and related notes for the three months ended March 31, 2011. 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 June 30,		Six Months Ended June 30,	
($ millions)	**2011**	2010	**2011**	2010
Cash flows from operating activities	**13.06**	12.74	**36.54**	33.48
Changes in non-cash operating working capital	**0.70**	5.50	**(7.56)**	6.74
Funds flow from operating activities	**13.76**	18.24	**28.98**	40.22

- *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, cash portion of 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 August 10, 2011, and contains forward-looking statements including:

- *our expectations for production referred to under the heading "Financial & Operating Highlights";*
- *our expectations for drilling referred to under the heading "Financial & Operating Highlights";*
- *our expectations for capital expenditures referred to under the heading "Financial & Operating Highlights";*
- *our expectations for the outcome of an ongoing tax audit referred to under the heading "Financial Analysis";*
- *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 August 10, 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 unaudited interim consolidated financial statements for the three and six months ended June 30, 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 20 of our June 30, 2011 unaudited interim 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 and six months ended June 30, 2010 and for the year ended December 31, 2010 and to the financial statements and related notes for the three months ended March 31, 2011.

The June 30, 2011 unaudited interim 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 June 30, 2011 unaudited 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:

- 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 and expired lands.
- 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 20 to the unaudited interim consolidated financial statements.

SUMMARY OF SIGNIFICANT EVENTS IN THE SECOND QUARTER

PETROLEUM AND NATURAL GAS REVENUE ($ millions)

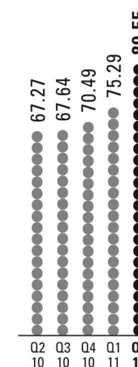
- The Company realized funds flow from operating activities of $13.76 million and declared dividends of $12.21 million ($10.47 million in cash after considering the common shares issued for the Dividend Reinvestment Plan, ("DRIP")) or $0.42 per common share to shareholders. For Canadian income tax purposes, 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 19 percent to $89.55 per barrel and increased five percent to $3.74 per thousand cubic feet, respectively, compared to the first quarter of 2011.
- Production averaged 8,686 barrels of oil equivalent per day and was nine percent lower than the preceding quarter and 14 percent lower than the corresponding 2010 quarter. As a result of 760 barrels of oil per day of shut-ins due to flooded leases and road bans in the Williston Basin core area, oil and liquids production averaged 5,034 barrels of oil per day in the second quarter, a 15 percent decrease from the prior quarter and a 12 percent decrease from the corresponding 2010 quarter.

- Three gross oil wells (2.1 net) were drilled with a 100 percent success rate. Total field exploration and development capital expenditures (excluding corporate and net property dispositions) were $7.73 million for the quarter compared to $22.25 million for the prior quarter.
- During the quarter, 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 were initially used to pay down debt and will subsequently partially fund the oil-focused 2011 capital program. Accordingly, debt net of working capital (excluding unrealized derivative assets/liabilities) was $102.12 million at the end of the 2011 second quarter, a 24 percent decrease from $135.13 million at the end of the 2011 first quarter. This June 30, 2011 balance represented approximately 57 percent of the Company's available credit facilities at June 30, 2011.
- On June 28, 2011, Zargon amended and renewed its syndicated committed credit facilities of $180 million. These facilities are available for general corporate purposes and the acquisition of oil and natural gas properties.

FINANCIAL ANALYSIS

Second quarter 2011 gross petroleum and natural gas sales of $48.47 million were three percent higher than the $46.94 million in the first quarter of 2011 and 10 percent above the $43.89 million in the second quarter of 2010. Second quarter 2011 realized oil and liquids field prices averaged $89.55 per barrel before the impact of financial risk management contracts and were 19 percent higher than the preceding quarter's $75.29 per barrel and 33 percent higher than the $67.27 per barrel recorded in the 2010 second quarter. Zargon's crude oil field price differential from the Edmonton par price increased to $13.54 per barrel in the second quarter of 2011 compared to $12.68 per barrel in the first quarter of 2011. Natural gas field prices received averaged $3.74 per thousand cubic feet in the second quarter of 2011, a five percent increase from the preceding quarter and a one percent increase from the 2010 second quarter prices.

OIL AND LIQUIDS PRICES ($/bbl)



Pricing

	Three Months Ended June 30,			Six Months Ended June 30,		
Average for the period	**2011**	2010	Percent Change	**2011**	2010	Percent Change
Natural Gas:						
NYMEX average daily spot price ($US/mmbtu)	**4.36**	4.32	1	**4.27**	4.73	(10)
AECO average daily spot price ($Cdn/mmbtu)	**3.87**	3.89	(1)	**3.83**	4.43	(14)
Zargon realized field price ($Cdn/mcf)	**3.74**	3.72	1	**3.65**	4.26	(14)
Zargon realized natural gas field price differential (1)	**0.13**	0.17		**0.18**	0.17	
Crude Oil:						
WTI ($US/bbl)	**102.56**	78.03	31	**98.30**	78.37	25
Edmonton par price ($Cdn/bbl)	**103.09**	75.18	37	**95.53**	77.63	23
Zargon realized field price before the impact of financial risk management contracts ($Cdn/bbl)	**89.55**	67.27	33	**81.90**	70.38	16
Zargon realized field price after the impact of financial risk management contracts ($Cdn/bbl)	**78.56**	69.98	12	**73.76**	72.94	1
Zargon realized oil field price differential (2)	**13.54**	7.91		**13.63**	7.25	

(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 stayed relatively constant in the second quarter of 2011 at 21.91 million cubic feet per day compared to 21.92 million cubic feet per day in the first quarter of 2011 and were 15

percent lower than the 2010 second quarter. Oil and liquids production volumes during the second quarter of 2011 were 5,034 barrels per day, which was 15 percent below the 2011 first quarter rate of 5,893 barrels per day and 12 percent below the second quarter of 2010 level. The decrease in the 2011 second quarter oil and liquids production was due to severe flooding and road bans in the Williston Basin, which caused approximately 760 barrels of oil per day to be shut-in for the quarter. On a barrel of oil equivalent basis, Zargon produced 8,686 barrels of oil equivalent per day in the second quarter of 2011, a nine percent decrease from the first quarter 2011 and a 14 percent decrease from the second quarter 2010.

Production by Core Area

Three Months Ended June 30,	**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	**1,210**	**18.15**	**4,235**	1,307	23.15	5,164
Alberta Plains South	**1,645**	**3.37**	**2,207**	1,413	1.95	1,738
Williston Basin	**2,179**	**0.39**	**2,244**	3,020	0.76	3,148
	5,034	**21.91**	**8,686**	5,740	25.86	10,050

Six Months Ended June 30,	**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	**1,220**	**18.13**	**4,243**	1,293	23.83	5,265
Alberta Plains South	**1,698**	**3.26**	**2,241**	1,376	1.87	1,688
Williston Basin	**2,543**	**0.52**	**2,629**	2,978	0.75	3,103
	5,461	**21.91**	**9,113**	5,647	26.45	10,056

Zargon's commodity price risk management policy, which is approved by the Board of Directors, allows for the sale of up to a 50 percent maximum of its estimated oil production for up to a 24 month period in order to meet capital program and dividend obligations in the event of significant commodity price declines. 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 second quarter, relatively higher oil prices versus contract prices resulted in a net realized loss on derivatives of $5.05 million on oil contracts compared to a $3.01 million realized net loss in the first quarter of 2011 and a $1.42 million realized net gain in the second quarter of 2010.

The unrealized gain on derivatives of $16.16 million in the second quarter of 2011 was comprised of oil contract gains of $16.14 million and electricity contract gains of $0.02 million, compared to a net $13.83 million loss for the 2011 first quarter and a net $6.99 million gain in the second 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 described in Note 4 to the unaudited interim consolidated financial statements.

Royalties, inclusive of the Saskatchewan Resource Surcharge ("SRC"), totalled $9.53 million for the second quarter of 2011, an increase of 26 percent from the $7.57 million preceding quarter expense and

an increase of 19 percent from $8.00 million in the second quarter of 2010. Although the variations in royalty rates generally track changes in production volumes and prices, the increase in the 2011 second quarter resulted mainly from a change in 2010 royalty estimates and SRC which were recorded in the period. Reflecting the 2011 commodity prices and the modified royalty structure, on a consolidated basis, the second quarter of 2011 royalties resulted in a rate of 19.7 percent compared to 16.1 percent in the first quarter of 2011. 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 $17.26 per barrel of oil equivalent in the second quarter of 2011 increased 13 percent from the preceding quarter and 37 percent from the $12.59 per barrel of oil equivalent in the second quarter of 2010. A significant component of this increase relates to the effect of the second quarter Williston Basin production shut-ins and the mostly fixed nature of Zargon's operating costs. In addition to the impact of decreased volumes in the quarter, per unit charges experienced increased cost pressures due to additional road and lease costs pertaining to efforts to regain production volumes, increased electricity costs, a prospective change in accounting estimate regarding the capitalization of workovers and general field operating cost inflation relating to oil field activities. Oil and natural gas liquids transportation costs in the second quarter of 2011 were $0.99 per barrel of oil equivalent, which compares to $0.77 per barrel of oil equivalent in the previous quarter and $0.57 per barrel of oil equivalent in the second quarter of 2010. 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 carryover into August, and combined production and transportation costs are not anticipated to return to our now targeted costs of $16.00 per barrel of oil equivalent until the 2011 fourth quarter.

Operating Netbacks

Three Months Ended June 30,	**2011**		2010	
	Oil and Liquids ($/bbl)	**Natural Gas ($/mcf)**	Oil and Liquids ($/bbl)	Natural Gas ($/mcf)
Sales	**89.55**	**3.74**	67.27	3.72
Royalties	**(18.20)**	**(0.60)**	(13.14)	(0.48)
Realized gain/(loss) on derivatives	**(10.99)**	**–**	2.71	–
Production costs	**(16.60)**	**(3.03)**	(12.15)	(2.19)
Transportation costs	**(0.99)**	**–**	(0.57)	–
Operating netbacks	**42.77**	**0.11**	44.12	1.05

Six Months Ended June 30,	**2011**		2010	
	Oil and Liquids ($/bbl)	**Natural Gas ($/mcf)**	Oil and Liquids ($/bbl)	Natural Gas ($/mcf)
Sales	**81.90**	**3.65**	70.38	4.26
Royalties	**(15.29)**	**(0.50)**	(13.95)	(0.56)
Realized gain/(loss) on derivatives	**(8.14)**	**–**	2.56	–
Production costs	**(15.41)**	**(2.91)**	(12.49)	(2.15)
Transportation costs	**(0.87)**	**–**	(0.56)	–
Operating netbacks	**42.19**	**0.24**	45.94	1.55

Measured on a unit of production basis (net of recoveries), general and administrative ("G&A") expenses were $5.02 per barrel of oil equivalent in the second quarter of 2011 compared to $4.74 in the second quarter of 2010 and $4.23 for the twelve month period of 2010. G&A expenses of $3.96 million for the second quarter of 2011 were nine percent lower than total G&A expenses for the second quarter of 2010,

and the increase on a unit of production basis is due solely to the lower production volumes in the first half of 2011.

On June 28, 2011, Zargon amended and renewed its syndicated committed credit facilities of $180 million. The next renewal date is June 27, 2012. These facilities continue to be available for general corporate purposes and the potential acquisition of oil and natural gas properties. Interest rates fluctuate under the syndicated facilities with Canadian prime, US prime and US base rates plus an applicable margin between 50 basis points and 200 basis points, as well as with Canadian banker's acceptance and LIBOR rates plus an applicable margin between 200 basis points and 350 basis points.

Zargon's borrowings are through its syndicated bank credit facilities. Interest and financing charges on these facilities in the 2011 second quarter were $1.30 million, 28 percent lower than the previous quarter amount of $1.81 million and 11 percent higher than the $1.17 million in the second quarter of 2010. In particular, bank debt levels were decreased in April 2011, when 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 share issue costs). The decrease from the previous quarter is also due to the below noted tax audit contingency provision, which was recorded in that quarter. The higher interest and financing charges compared to the second quarter of 2010 result from 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. No additional charges were recorded in the second quarter and, at this time, Zargon is uncertain of the timing and final outcome of this matter.

Current income taxes for the 2011 second quarter were $0.24 million, and relate to the United States operations. When compared to prior periods, current income taxes decreased $0.57 million from the 2010 second quarter and decreased $1.13 million relative to the first quarter of 2011, mainly due to the tax contingency mentioned above. Total corporate tax pools as at June 30, 2011, are approximately $351 million, which represents an increase of one percent from the comparable $346 million of tax pools available to Zargon at December 31, 2010, primarily as a result of the 2011 first half field capital program.

Exploration and evaluation expenses for the 2011 second quarter of $0.72 million were $0.14 million lower than the $0.86 million incurred in the first quarter of 2011 and were $0.02 million higher than the second quarter of 2010 expenses of $0.70 million. Exploration and evaluation expenses are mainly driven by land expiries in a quarter.

Corporate Netbacks

	Three Months Ended June 30,		Six Months Ended June 30,	
($/boe)	**2011**	2010	**2011**	2010
Petroleum and natural gas sales	**61.32**	47.99	**57.85**	50.73
Royalties	**(12.05)**	(8.74)	**(10.37)**	(9.32)
Realized gain/(loss) on derivatives	**(6.39)**	1.55	**(4.88)**	1.43
Production costs	**(17.26)**	(12.59)	**(16.25)**	(12.69)
Transportation costs	**(0.57)**	(0.32)	**(0.52)**	(0.31)
Operating netbacks	**25.05**	27.89	**25.83**	29.84
General and administrative	**(5.02)**	(4.74)	**(4.55)**	(4.35)
Exploration and evaluation expense	**0.27**	(0.15)	**–**	(0.22)
Interest and financing charges	**(1.64)**	(1.28)	**(1.88)**	(1.22)
Asset retirement expenditures	**(0.94)**	(0.87)	**(0.85)**	(1.09)
Capital and current income taxes	**(0.31)**	(0.89)	**(0.98)**	(0.86)
Funds flow netbacks	**17.41**	19.96	**17.57**	22.10

FUNDS FLOW NETBACKS ($/boe)

Depletion and depreciation expense for the second quarter of 2011 decreased 10 percent to $11.45 million from $12.78 million in the prior quarter and decreased eight percent when compared to the second quarter of 2010 expense of $12.49 million. On a per barrel of oil equivalent basis, the depletion and depreciation rates were $14.48, $14.87 and $13.65 for the second and first quarters of 2011 and the second quarter of 2010, respectively. The 2010 calendar year depletion and depreciation rate was $13.65 per barrel of oil equivalent.

FUNDS FLOW FROM OPERATING ACTIVITIES ($ millions)

The accretion expense of asset retirement obligations for the first half of 2011 was $1.61 million, a nine percent increase compared to the first half 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.

Expensing of share-based compensation in the second quarter of 2011 totalled $0.51 million, which is higher than the $0.22 million incurred in the second quarter of 2010 mainly due to the new share-based plan implemented on January 1, 2011 in conjunction with the corporate conversion, but slightly lower than the $0.58 million incurred in the first quarter of 2011.

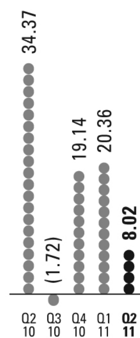
The deferred tax expense for the second quarter of 2011 was $4.26 million compared to a recovery of $3.43 million in the prior quarter and a recovery of $0.44 million in the second quarter of 2010. As a corporation, Zargon's deferred tax obligations are not reduced by dividend declarations. Prior to 2011, as a trust, cash distributions were 100 percent deductible. This change in tax structure is the primary reason for the 2011 second quarter tax expense relative to the 2010 second quarter recovery.

FUNDS FLOW PER SHARE ($/share - diluted)

Funds flow from operating activities in the 2011 second quarter of $13.76 million was $1.46 million, or 10 percent lower than the preceding quarter and $4.48 million or 25 percent lower than the prior year second quarter. The decrease in funds flow compared to the prior year second quarter was primarily a result of lower production volumes, increased realized derivative losses and higher production expenses. Funds flow on a per diluted common share basis of $0.47 for the second quarter of 2011 is 16 percent lower than the prior quarter and is 33 percent lower than the 2010 second quarter.

Net earnings of $12.67 million for the 2011 second quarter were significantly improved compared to the $9.11 million of net losses in the preceding quarter, which resulted largely from unrealized derivative losses, but decreased from the $17.86 million of net earnings in the second quarter of 2010. 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

NET CAPITAL
EXPENDITURES
($ millions)



derivatives gains/losses, land expiries and deferred taxes. On a per diluted share basis, second quarter 2011 net earnings were $0.43 compared to net losses of $0.33 for the 2011 first quarter and net earnings of $0.68 for the 2010 second quarter.

Capital Expenditures

	Three Months Ended June 30,		Six Months Ended June 30,	
($ millions)	**2011**	2010	**2011**	2010
Undeveloped land	**1.34**	2.22	**2.73**	3.44
Geological and geophysical (seismic)	**1.22**	1.06	**1.73**	1.53
Drilling and completion of wells	**2.17**	7.94	**17.70**	16.09
Well equipment and facilities	**3.00**	5.25	**7.82**	9.98
Exploration and development	**7.73**	16.47	**29.98**	31.04
Property acquisitions	**0.27**	24.86	**0.33**	29.42
Property dispositions	**(0.12)**	(7.05)	**(2.12)**	(8.05)
Net property acquisitions/(dispositions)	**0.15**	17.81	**(1.79)**	21.37
Total net capital expenditures excluding administrative assets	**7.88**	34.28	**28.19**	52.41
Administrative assets	**0.14**	0.09	**0.19**	0.20
Total net capital expenditures	**8.02**	34.37	**28.38**	52.61

SUBSEQUENT EVENT

In July 2011, Zargon completed two property dispositions in the Williston Basin core area for total cash consideration of approximately $24.5 million. In aggregate, the properties were producing 260 barrels of oil per day and included 7.8 thousand net acres of undeveloped land.

LIQUIDITY AND CAPITAL RESOURCES

Total net capital expenditures (including net property acquisitions) of $8.02 million in the second quarter of 2011 were 77 percent lower than the same period in 2010. Field expenditures of $7.73 million for the second quarter of 2011 were 53 percent lower than the 2010 second quarter. Due to restricted field access in the second quarter, Zargon drilled 2.1 net wells in the second quarter compared to 6.3 net wells drilled in the same period in 2010. Field capital expenditures (excluding net property dispositions) for the first half of 2011 were allocated to Alberta Plains North – $9.84 million, Alberta Plains South – $5.96 million and Williston Basin – $14.18 million.

NET DEBT
PER SHARE
($/share - diluted)

Funds flow from operating activities in the first half of 2011 of $28.98 million and proceeds from the issuance of common shares of $40.37 million (due to share right exercises and the equity issuance) funded the decrease in bank debt, the capital program, the changes in working capital and the cash dividends to shareholders.

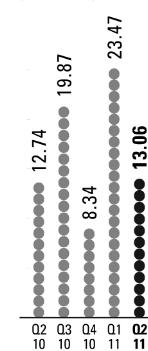
At June 30, 2011, the Company's combined debt net of working capital (excluding unrealized derivative assets/liabilities) was $102.12 million, which represents approximately 57 percent of the Company's available credit facilities at June 30, 2011 and compares to $124.39 million of net debt at the end of 2010.

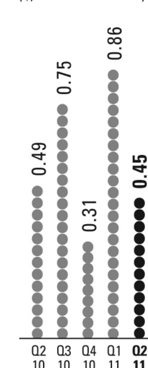
The volatility of oil and natural gas prices, uncertainty or modifications regarding royalties and Canadian income tax rules and global economic/political concerns have, on occasion, restricted the oil and natural gas industry's ability to attract new capital from debt and equity markets.

Cash Dividends Analysis

	Three Months Ended June 30,		Six Months Ended June 30,	
($ millions)	**2011**	2010	**2011**	2010
Cash flows from operating activities	**13.06**	12.74	**36.54**	33.48
Net earnings	**12.67**	17.86	**3.56**	22.21
Actual cash dividends paid or payable relating to the period [(1)]	**(10.47)**	(11.88)	**(20.12)**	(24.43)
Excess of cash flows from operating activities over cash dividends paid	**2.59**	0.86	**16.42**	9.05
Excess (shortfall) of net earnings over cash dividends paid	**2.20**	5.98	**(16.56)**	(2.22)

(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 half 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/exploitation, development and acquisition activities to replace reserves and to offset production declines. The success of these exploration/exploitation, 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 and six months ended June 30, 2011, cash flows from operating activities (after changes in non-cash working capital) of $13.06 million and $36.54 million, respectively, exceeded cash dividends of $10.47 million and $20.12 million, respectively. Similarly, for the three and six months ended June 30, 2010, cash flows from operating activities (after changes in non-cash working capital) of $12.74 million and $33.48 million, respectively, exceeded cash distributions of $11.88 million and $24.43 million, respectively.

For the three months ended June 30, 2011, net earnings of $12.67 million exceeded cash dividends of $10.47 million and for the six months ended June 30, 2011, cash dividends of $20.12 million exceeded net earnings of $3.56 million. Net earnings include significant non-cash charges of $1.83 million for the 2011 second quarter and $26.81 million for the six months ended June 30, 2011, that do not impact cash flow. For the three months ended June 30, 2010, net earnings of $17.86 million exceeded cash distributions of $11.88 million while for the six months ended June 30, 2010, cash distributions of $24.43 million exceeded net earnings of $22.21 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 June 30 2011, cash dividends and net capital expenditures totalled $18.49 million, which was $5.43 million higher than the cash flows from operating activities (after changes in non-cash working capital) of $13.06 million. For the quarter ended June 30, 2010, cash distributions and net capital expenditures totalled $46.25 million, which was $33.51 million higher than the cash flows from operating activities (after changes in non-cash working capital) of $12.74 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 may 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 August 10, 2011, Zargon Oil & Gas Ltd. had 29.130 million common shares outstanding. Pursuant to the common share rights incentive plans, there are currently an additional 1.209 million common share incentive rights issued and outstanding.

Capital Sources and Uses

	Three Months Ended June 30,		Six Months Ended June 30,	
($ millions)	**2011**	2010	**2011**	2010
Funds flow from operating activities	**13.76**	18.24	**28.98**	40.22
Change in bank debt	**(26.10)**	29.89	**(19.49)**	37.54
Issuance of common shares	**37.55**	0.09	**40.37**	1.88
Cash dividends to shareholders [(1)]	**(10.47)**	(11.88)	**(20.12)**	(24.43)
Changes in working capital and other	**(6.72)**	(1.97)	**(1.36)**	(2.60)
Total capital sources	**8.02**	34.37	**28.38**	52.61

(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 for the six months ended June 30, 2011.

FUTURE CHANGES IN ACCOUNTING POLICIES

IFRS 9 "Financial Instruments", which was issued in October 2010, is the first phase in the replacement of IAS 39 "Financial Instruments: Recognition and Measurement". IFRS 9 revises the current multiple classification and measurement models for financial assets and liabilities and limits the models to two: amortized cost or fair value. The 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.

IFRS 10 "Consolidated Financial Statements", which was issued in May 2011, identifies the concept of control as the determining factor in whether an investee should be included within the consolidated financial statements of the parent. The guidance requires an entity to consolidate an investee when it has exposure or rights to variable returns from its involvement with the investee and has the ability to affect those returns. The standard applies to all investees, including special purpose entities and replaces SIC-12 "Consolidation – Special Purpose Entities" and parts of IAS 27 "Consolidated and Separate Financial Statements". The 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.

IFRS 11 "Joint Arrangements" was issued in May 2011 and addresses two forms of joint arrangements where there is joint control: joint operations and joint ventures. In a joint operation, each venturer will recognize its share of the operation's assets, liabilities, revenues and expenses. Joint ventures will be required to use the equity method of accounting. IFRS 11 replaces IAS 31 "Interests in Joint Ventures" and SIC-13 "Jointly-controlled Entities – Non-Monetary Contributions from Venturers". The 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.

IFRS 12 “Disclosure of Interests in Other Entities” was issued in May 2011. It is a comprehensive standard addressing disclosure requirements for all forms of interests in other entities, including joint arrangements, associates, subsidiaries, special purpose entities and unconsolidated structured entities. The standard aims to provide information to enable users to evaluate the nature of an entity’s interest in other entities and the associated risks. IFRS 12 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.

IFRS 13 “Fair Value Measurement”, which was also issued in May 2011, replaces fair value measurement and disclosure guidance throughout individual IFRS standards with one comprehensive source of fair value measurement guidance. IFRS 13 defines fair value as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. The standard also provides a framework for measurement of fair value and establishes required disclosures. It 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.

IAS 1 “Presentation of Items of Other Comprehensive Income” was amended in June 2011 to require that items within other comprehensive income, which are reclassified to earnings, be grouped together within the statement of other comprehensive income. The amendment is effective for the Company’s interim and annual consolidated financial statements commencing July 1, 2012. The Company is currently assessing the impact of the changes to this standard on its consolidated financial statements.

IAS 19 “Employee Benefits” was amended in June 2011 with revisions to certain aspects of the accounting for pension plans and other benefits, including amendments to the recognition, disaggregation, presentation and disclosure of deferred benefit plans. The amendments are effective for the Company’s interim and annual consolidated financial statements commencing January 1, 2013. The Company is currently assessing the impact of the amendments on its consolidated financial statements.

In addition, there have been amendments to existing standards, including IAS 27 “Separate Financial Statements” and IAS 28 “Investments in Associates and Joint Ventures”, as a result of the introduction of IFRS 10 through 13 discussed above.

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 no such changes were made to the internal controls over financial reporting during the second quarter 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 strong balance sheet and 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

	2011	
	Q1	**Q2**
Petroleum and natural gas sales, before royalties ($ millions)	46.94	**48.47**
Net earnings/(losses) ($ millions)	(9.11)	**12.67**
Net earnings/(losses) per diluted share ($)	(0.33)	**0.43**
Funds flow from operating activities ($ millions)	15.22	**13.76**
Funds flow from operating activities per diluted share ($)	0.56	**0.47**
Cash flows from operating activities ($ millions)	23.47	**13.06**
Cash flows from operating activities per diluted share ($)	0.86	**0.45**
Cash dividends ($ millions) [(1)]	9.65	**10.47**
Cash dividends declared per common share ($)	0.42	**0.42**
Net capital expenditures ($ millions)	20.36	**8.02**
Total assets ($ millions)	483.98	**472.58**
Bank debt ($ millions)	121.89	**95.79**
Average daily production (boe)	9,546	**8,686**
Average realized commodity field price before the impact of financial risk management contracts ($/boe)	54.64	**61.32**
Funds flow netback ($/boe)	17.71	**17.41**

(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.

	2010			
	Q1	Q2	Q3	Q4
Petroleum and natural gas sales, before royalties ($ millions)	48.46	43.89	44.50	42.64
Net earnings/(losses) ($ millions)	4.35	17.86	1.20	(36.29)
Net earnings/(losses) per diluted unit ($)	0.17	0.68	0.05	(1.35)
Funds flow from operating activities ($ millions)	21.98	18.24	18.31	14.40
Funds flow from operating activities per diluted unit ($)	0.84	0.70	0.69	0.54
Cash flows from operating activities ($ millions)	20.74	12.74	19.87	8.34
Cash flows from operating activities per diluted unit ($)	0.79	0.49	0.75	0.31
Cash distributions ($ millions) [(1)]	12.55	11.88	11.92	10.99
Cash distributions declared per trust unit ($)	0.54	0.54	0.54	0.54
Net capital expenditures ($ millions) [(2)]	18.24	34.37	(1.72)	19.14
Total assets ($ millions)	466.94	495.98	481.90	472.25
Bank debt ($ millions)	84.23	114.12	97.61	115.29
Average daily production (boe)	10,062	10,050	10,094	9,317
Average realized commodity field price before the impact of financial risk management contracts ($/boe)	53.51	47.99	47.91	49.74
Funds flow netback ($/boe)	24.27	19.96	19.70	16.81

(1) Cash distributions represent the cash portion only and do not include trust units issued through Zargon's Distribution 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
August 10, 2011

CONSOLIDATED BALANCE SHEETS

(unaudited)

($ thousands)	Notes	**June 30, 2011**	December 31, 2010 (restated Note 20)
ASSETS	10		
Trade and other receivables		**21,716**	22,883
Deposits and prepaid expenses		**2,036**	2,191
Total current assets		**23,752**	25,074
Long term deposits		**418**	653
Derivatives	4	**373**	–
Property, plant and equipment, net	9	**414,969**	412,119
Intangible exploration and evaluation assets		**27,074**	27,708
Goodwill		**2,969**	2,969
Deferred tax assets		**3,020**	3,723
Total non-current assets		**448,823**	447,172
Total assets		**472,575**	472,246
LIABILITIES			
Trade and other payables		**26,612**	30,431
Cash dividends/distributions payable	18	**3,471**	3,750
Derivatives	4	**10,440**	10,737
Total current liabilities		**40,523**	44,918
Long term debt	10	**95,792**	115,285
Derivatives	4	**1,425**	3,080
Provisions	14	**98,099**	96,395
Deferred tax liabilities		**4,171**	4,870
Total non-current liabilities		**199,487**	219,630
Total liabilities		**240,010**	264,548
Commitments and contingencies	4,10,12,14,15		
EQUITY			
Shareholders' capital	11	**246,234**	201,091
Accumulated other comprehensive loss		**(1,798)**	(1,208)
Contributed surplus	12	**8,177**	7,815
Retained earnings/(deficit)		**(20,048)**	–
Total equity		**232,565**	207,698
Total equity and liabilities		**472,575**	472,246

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF EARNINGS AND COMPREHENSIVE INCOME

(unaudited)		Three Months Ended June 30,		Six Months Ended June 30,	
($ thousands, except per share amounts)	Notes	**2011**	2010 (restated Note 20)	**2011**	2010 (restated Note 20)
Petroleum and natural gas sales		**48,471**	43,886	**95,412**	92,342
Royalties		**(9,528)**	(7,995)	**(17,098)**	(16,959)
PETROLEUM AND NATURAL GAS REVENUE, NET OF ROYALTIES		**38,943**	35,891	**78,314**	75,383
Gain on unrealized derivatives	4	**16,156**	6,990	**2,325**	3,663
Gain/(loss) on realized derivatives	4	**(5,049)**	1,417	**(8,058)**	2,597
OTHER INCOME/(EXPENSE)		**11,107**	8,407	**(5,733)**	6,260
		50,050	44,298	**72,581**	81,643
Production and operating expenses		**13,642**	11,512	**26,798**	23,086
Transportation expenses		**451**	296	**858**	570
Exploration and evaluation expenses		**724**	699	**1,586**	1,204
General and administrative expenses		**3,964**	4,337	**7,501**	7,914
Gain on disposal of properties		**–**	(1,362)	**(234)**	(1,362)
Exchangeable shares revaluation		**–**	(4,081)	**–**	–
Share-based compensation	12	**514**	223	**1,098**	672
Unrealized foreign exchange loss		**26**	–	**26**	–
Depletion and depreciation		**11,445**	12,487	**24,220**	24,600
EXPENSES		**30,766**	24,111	**61,853**	56,684
		19,284	20,187	**10,728**	24,959
Interest and financing charges	10	**1,298**	1,173	**3,104**	2,243
Accretion of asset retirement obligations	14	**807**	776	**1,609**	1,476
FINANCE EXPENSES		**2,105**	1,949	**4,713**	3,719
EARNINGS BEFORE INCOME TAXES		**17,179**	18,238	**6,015**	21,240
Current tax expense		**244**	817	**1,622**	1,565
Deferred tax expense (recovery)		**4,263**	(440)	**833**	(2,537)
INCOME TAXES		**4,507**	377	**2,455**	(972)
NET EARNINGS FOR THE PERIOD		**12,672**	17,861	**3,560**	22,212
Currency translation adjustment, net of tax [1]		**(121)**	665	**(440)**	216
OTHER COMPREHENSIVE INCOME/(LOSS) FOR THE PERIOD		**(121)**	665	**(440)**	216
TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE PERIOD		**12,551**	18,526	**3,120**	22,428
NET EARNINGS/(LOSSES) PER SHARE					
Basic	13	**0.44**	0.76	**0.13**	0.95
Diluted	13	**0.43**	0.68	**0.13**	0.85

(1) Includes tax for the three and six months ended June 30, 2011 of $0.04 million (2010 – $0.26 million) and $0.15 million (2010 – $0.09 million).

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(unaudited)						Six Months Ended June 30,
($ 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 for the period		**–**	**–**	**–**	**3,560**	**3,560**
Dividends declared	18	**–**	**–**	**–**	**(23,608)**	**(23,608)**
Issue of common shares pursuant to the DRIP	11,18	**3,488**	**–**	**–**	**–**	**3,488**
Issue of common shares pursuant to financing	11	**38,985**	**–**	**–**	**–**	**38,985**
Share issue costs, net of deferred tax effect of $524	11	**(1,530)**	**–**	**–**	**–**	**(1,530)**
Share-based payments	12	**–**	**–**	**1,120**	**–**	**1,120**
Exercise of share options	11	**4,200**	**–**	**(758)**	**–**	**3,442**
Translation differences on foreign subsidiary		**–**	**(590)**	**–**	**–**	**(590)**
Balance at June 30, 2011		**246,234**	**(1,798)**	**8,177**	**(20,048)**	**232,565**
Balance at January 1, 2010 (restated, Note 20)		188,840	–	–	(7,699)	181,141
Net earnings for the period		–	–	–	22,212	22,212
Dividends/distributions declared		–	–	–	(25,167)	(25,167)
Issue of common shares on exchangeables		2,830	–	–	–	2,830
Issue of common shares pursuant to the DRIP	11,18	734	–	–	–	734
Exercise of unit options		2,218	–	–	–	2,218
Translation differences on foreign subsidiary		–	301	–	–	301
Balance at June 30, 2010 (restated, Note 20)		194,622	301	–	(10,654)	184,269

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)		Three Months Ended June 30,		Six Months Ended June 30,	
($ thousands)	Notes	**2011**	2010	**2011**	2010
OPERATING ACTIVITIES					
Net earnings for the period		**12,672**	17,861	**3,560**	22,212
Adjustments for non-cash items:					
Exchangeable shares revaluation		**–**	(4,081)	**–**	–
Gain on sale of properties		**–**	(1,362)	**(234)**	(1,362)
Change in fair value of unrealized derivatives		**(16,156)**	(6,990)	**(2,325)**	(3,663)
Depletion and depreciation		**11,445**	12,487	**24,220**	24,600
Accretion of asset retirement obligations		**807**	776	**1,609**	1,476
Share-based compensation		**514**	223	**1,098**	672
Unrealized foreign exchange loss		**26**	–	**26**	–
Deferred taxes (recovery)		**4,263**	(440)	**833**	(2,537)
Exploration and evaluation expenses		**931**	565	**1,586**	808
Asset retirement expenditures		**(741)**	(798)	**(1,396)**	(1,986)
		13,761	18,241	**28,977**	40,220
Changes in operating working capital	7	**(698)**	(5,506)	**7,559**	(6,745)
Net cash from operating activities		**13,063**	12,735	**36,536**	33,475
INVESTING ACTIVITIES					
Additions to property, plant and equipment		**(7,670)**	(39,701)	**(29,458)**	(58,490)
Additions to intangible exploration and evaluation assets		**(465)**	(1,481)	**(1,039)**	(2,167)
Proceeds on disposal of property, plant and equipment		**121**	7,051	**2,117**	8,051
Change in long term deposit		**235**	1,203	**235**	1,203
Changes in investing working capital	7	**(6,508)**	3,176	**(8,872)**	3,144
Net cash used in investing activities		**(14,287)**	(29,752)	**(37,017)**	(48,259)
FINANCING ACTIVITIES					
Advances/(repayments) of bank debt		**(26,101)**	29,890	**(19,493)**	37,539
Cash dividends/distributions paid to shareholders		**(10,471)**	(11,882)	**(20,120)**	(24,433)
Proceeds from exercise of share rights		**621**	88	**3,442**	1,881
Issuance of shareholders' capital, net of issue costs		**36,931**	–	**36,931**	–
Changes in financing working capital	7	**244**	(1,079)	**(279)**	(203)
Net cash used in financing activities		**1,224**	17,017	**481**	14,784
NET CHANGE IN CASH DURING THE PERIOD AND CASH, END OF PERIOD		**–**	–	**–**	–

See accompanying notes to the interim consolidated financial statements.

For the three and six months ended June 30, 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 at Suite 700, 333-5th Avenue SW, Calgary, Alberta. The interim consolidated financial statements of the Company as at and for the periods ended June 30, 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. In these financial statements, the term "Canadian GAAP" refers to Canadian generally accepted accounting principles before the adoption of IFRS.

The interim consolidated financial statements for the three and six month periods ended June 30, 2011 have been prepared in accordance with IAS 34 "Interim Financial Reporting". The same accounting policies and methods of computation were followed in the preparation of these interim consolidated financial statements as were followed in the preparation of the interim consolidated financial statements for the three month period ended March 31, 2011. In addition, the interim consolidated financial statements for the three month period ended March 31, 2011 contains certain incremental annual IFRS disclosure not included in the annual financial statements for the year ended December 31, 2010 prepared in accordance with pre-changeover Canadian GAAP. Accordingly, these interim consolidated financial statements for the three and six month periods ended June 30, 2011 should be read together with the annual consolidated financial statements for the year ended December 31, 2010 prepared in accordance with pre-changeover Canadian GAAP as well as the interim consolidated financial statements for the three month period ended March 31, 2011.

The policies applied in these interim consolidated financial statements are based on IFRS issued and outstanding as of August 10, 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.

(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.

(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.

If 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.

3. CHANGES IN ACCOUNTING POLICIES

(a) New and amended standards adopted by the Company

Refer to Note 20.

(b) 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, is the first phase in the replacement of IAS 39 "Financial Instruments: Recognition and Measurement". IFRS 9 revises the current multiple classification and measurement models for financial assets and liabilities and limits the models to two: amortized cost or fair value. The 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.

IFRS 10 "Consolidated Financial Statements", which was issued in May 2011, identifies the concept of control as the determining factor in whether an investee should be included within the consolidated financial statements of the parent. The guidance requires an entity to consolidate an investee when it has exposure or rights to variable returns from its involvement with the investee and has the ability to affect those returns. The standard applies to all investees, including special purpose entities and replaces SIC-12 "Consolidation – Special Purpose Entities" and parts of IAS 27 "Consolidated and Separate Financial Statements". The 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.

IFRS 11 "Joint Arrangements" was issued in May 2011 and addresses two forms of joint arrangements where there is joint control: joint operations and joint ventures. In a joint operation, each venturer will recognize its share of the operation's assets, liabilities, revenues and expenses. Joint ventures will be required to use the equity method of accounting. IFRS 11 replaces IAS 31 "Interests in Joint Ventures" and SIC-13 "Jointly-controlled Entities – Non-Monetary Contributions from Venturers". The 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.

IFRS 12 "Disclosure of Interests in Other Entities" was issued in May 2011. It is a comprehensive standard addressing disclosure requirements for all forms of interests in other entities, including joint arrangements, associates, subsidiaries, special purpose entities and unconsolidated structured entities. The standard aims to provide information to enable users to evaluate the nature of

an entity's interest in other entities and the associated risks. IFRS 12 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.

IFRS 13 "Fair Value Measurement", which was also issued in May 2011, replaces fair value measurement and disclosure guidance throughout individual IFRS standards with one comprehensive source of fair value measurement guidance. IFRS 13 defines fair value as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. The standard also provides a framework for measurement of fair value and establishes required disclosures. It 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.

IAS 1 "Presentation of Items of Other Comprehensive Income" was amended in June 2011 to require that items within other comprehensive income, which are reclassified to earnings, be grouped together within the statement of other comprehensive income. The amendment is effective for the Company's interim and annual consolidated financial statements commencing July 1, 2012. The Company is currently assessing the impact of the changes to this standard on its consolidated financial statements.

IAS 19 "Employee Benefits" was amended in June 2011 with revisions to certain aspects of the accounting for pension plans and other benefits, including amendments to the recognition, disaggregation, presentation and disclosure of deferred benefit plans. The amendments are effective for the Company's interim and annual consolidated financial statements commencing January 1, 2013. The Company is currently assessing the impact of the amendments on its consolidated financial statements.

In addition, there have been amendments to existing standards, including IAS 27 "Separate Financial Statements" and IAS 28 "Investments in Associates and Joint Ventures", as a result of the introduction of IFRS 10 through 13 discussed above.

4. DERIVATIVES

The Company is a party to certain financial instruments that have fixed the price of a portion of its oil production and electricity 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 electricity 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 gain on the statement of earnings and comprehensive income for the first half of 2011 was $2.33 million and the unrealized gain for the first half in 2010 was $3.66 million.

As at June 30, 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 Asset/(Liability) ($ thousands)
Oil swaps	300 bbl/d	$77.25 US/bbl	Jul. 1/11 – Sep. 30/11	(503)
	1,100 bbl/d	$83.33 US/bbl	Jul. 1/11 – Dec. 31/11	(2,649)
	800 bbl/d	$86.81 US/bbl	Jul. 1/11 – Jun. 30/12	(3,204)
	200 bbl/d	$83.50 US/bbl	Jul. 1/11 – Aug. 31/12	(1,238)
	400 bbl/d	$85.54 US/bbl	Jul. 1/11 – Sep. 30/12	(2,311)
	200 bbl/d	$87.65 US/bbl	Oct. 1/11 – Sep. 30/12	(819)
	600 bbl/d	$94.78 US/bbl	Jan. 1/12 – Dec. 31/12	(1,112)
	300 bbl/d	$100.00 US/bbl	Jan. 1/12 – Mar. 31/13	(28)
	200 bbl/d	$107.80 US/bbl	Jul. 1/12 – Mar. 31/13	373
Total Fair Market Value, Commodity Price Financial Contracts				**(11,491)**

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	Jul. 1/11 – Dec. 31/11	(1)
Total Fair Market Value, Electricity Financial Contracts				**(1)**

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.

5. 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)	**June 30, 2011**	December 31, 2010
Net debt	**102,123**	124,392
Annualized funds flow from operating activities	**58,434**	72,932
Net debt to funds flow from operating activities ratio	**1.75**	1.71

As at June 30, 2011, Zargon's net debt to funds flow from operating activities ratio was 1.75, an increase from 1.71 at December 31, 2010. Bank debt levels decreased in the current quarter when Zargon closed an offering of 1.725 million common shares on a bought deal basis of $22.60 per share for total gross proceeds of $38.99 million ($36.93 million net of issue costs). On June 28, 2011, Zargon amended and renewed its syndicated committed credit facilities of $180 million. The next renewal date is June 27, 2012. These facilities continue to be available for general corporate purposes and the potential acquisition of oil and natural gas properties.

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 as at June 30, 2011.

6. 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 were $0.13 million.

7. CHANGE IN NON-CASH FLOW INFORMATION

The net change in working capital is comprised of:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ thousands)	**2011**	2010	**2011**	2010
Source/(use) of cash:				
Trade and other receivables	**3,065**	2,429	**1,167**	2,624
Deposit and prepaid expenses	**60**	(1,390)	**155**	(997)
Accounts payable and accrued liabilities	**(10,276)**	(4,385)	**(3,819)**	(5,303)
Cash dividends/distributions payable	**244**	(247)	**(279)**	(202)
Provisions	**–**	–	**1,270**	–
Foreign exchange and other	**(55)**	184	**(86)**	74
	(6,962)	(3,409)	**(1,592)**	(3,804)
Related to operating activities	**(698)**	(5,506)	**7,559**	(6,745)
Related to investing activities	**(6,508)**	3,176	**(8,872)**	3,144
Related to financing activities	**244**	(1,079)	**(279)**	(203)
	(6,962)	(3,409)	**(1,592)**	(3,804)

8. SUPPLEMENTAL CASH FLOW INFORMATION

	Three Months Ended June 30,		Six Months Ended June 30,	
($ thousands)	**2011**	2010	**2011**	2010
Cash interest paid	**1,678**	1,541	**3,242**	2,295
Cash taxes paid	**480**	189	**501**	2,209

9. PROPERTY, PLANT AND EQUIPMENT AND IMPAIRMENT

	June 30, 2011		
($ thousands)	**Cost**	**Accumulated Depletion and Depreciation**	**Net Book Value**
Developed and Producing Assets and Office Equipment	**488,260**	**73,291**	**414,969**

	December 31, 2010		
($ thousands)	Cost	Accumulated Depletion and Depreciation	Net Book Value
Developed and Producing Assets and Office Equipment	461,264	49,145	412,119

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 lower than its recoverable amount, and an impairment loss of $22.87 million was recognized. In 2011, the Company has not reversed any impairment and there have been no further impairments.

10. LONG TERM DEBT

On June 28, 2011, 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. 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 365 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 27, 2012. Should the facilities not be renewed, they convert to one year non-revolving term facilities at the end of the revolving 365 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 50 basis points and 200 basis points as well as with Canadian banker's acceptance and LIBOR rates plus an applicable margin between 200 basis points and 350 basis points. At June 30, 2011, $95.79 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 June 30, 2011, the approximate value of outstanding letters of credit totalled $1.47 million (December 31, 2010 - $1.25 million). The letters of credit reduce the amount of Zargon's available credit facilities to $82.74 million at June 30, 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 June 30, 2011.

11. SHARE CAPITAL

Pursuant to the Arrangement on December 31, 2010, 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

(thousands)	June 30, 2011 Number of Shares	Amount ($)
Balance, beginning of period	**27,046**	**201,091**
Share options exercised for cash	**190**	**3,442**
Share-based compensation recognized on exercise of share options	**–**	**758**
Equity Issuance	**1,725**	**38,985**
Share issue costs, net of deferred tax effect of $524	**–**	**(1,530)**
Issued pursuant to the Dividend Reinvestment Plan	**167**	**3,488**
Balance, end of period	**29,128**	**246,234**

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).

Trust Units

(thousands)	December 31, 2010 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 6]	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 20(m)]	–	(71,335)
Balance, as at December 31, 2010	27,046	201,091

12. SHARE-BASED PAYMENTS

Share Award Plan

On December 15, 2010, a 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 awards plus all notional dividends accrued since the grant date.

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

	Six Months Ended June 30, 2011
	Number of Share Awards (thousands)
Outstanding at beginning of period	–
Share awards granted	178
Share awards forfeited	(13)
Outstanding at end of period	165

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:

	Six Months Ended June 30, 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	(114)	20.89
Share options expired	(145)	31.49
Share options forfeited	(23)	26.69
Outstanding at end of period	456	24.24 / 22.05

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

	Six Months Ended June 30, 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	(77)	13.81
Share options forfeited	(37)	18.61
Outstanding at end of period	594	18.14 / 14.97

Share-based Compensation

The weighted average assumptions used for share awards granted in the six months ended June 30, 2011 include a volatility factor of expected market price of 30.95 percent, a risk-free interest rate of 2.27 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 $19.63 per share award. These share awards, together with the continued vesting of options granted in prior years, resulted in share-based compensation expense for the three and six months ended June 30, 2011 of $0.51 million (2010 – $0.22 million) and $1.10 million (2010 – $0.67 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 on the vesting date.

13. WEIGHTED AVERAGE NUMBER OF TOTAL SHARES

	Three Months Ended June 30,		Six Months Ended June 30,	
(thousands of shares)	**2011**	2010	**2011**	2010
Weighted average number of common shares – basic	**28,929**	23,377	**28,024**	23,376
Weighted average number of common shares – diluted	**29,142**	26,235	**28,246**	26,220

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.

14. PROVISIONS

($ thousands)	**Asset retirement obligations**	**Other**	**Total**
Balance at January 1, 2011	**96,395**	**–**	**96,395**
Provisions made during the period	**280**	**1,270**	**1,550**
Foreign exchange and other	**(59)**	**–**	**(59)**
Provisions used during the period	**(1,396)**	**–**	**(1,396)**
Accretion	**1,609**	**–**	**1,609**
Balance at June 30, 2011	**96,829**	**1,270**	**98,099**

($ 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

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.

15. CONTINGENCIES AND COMMITMENTS

There have been no significant changes to Zargon's contingencies and commitments since March 31, 2011.

16. SIGNIFICANT SUBSIDIARIES

The Company has the following significant wholly owned subsidiaries which are incorporated and one partnership 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.

17. 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 June 30, 2011		
($ thousands)	**Canada**	**United States**	**Combined**
Petroleum and natural gas revenue, net of royalties	**35,793**	**3,150**	**38,943**
Earnings before income taxes	**15,253**	**1,926**	**17,179**
Net capital expenditures	**7,277**	**737**	**8,014**

	Six Months Ended June 30, 2011		
($ thousands)	**Canada**	**United States**	**Combined**
Petroleum and natural gas revenue, net of royalties	**72,370**	**5,944**	**78,314**
Earnings before income taxes	**2,538**	**3,477**	**6,015**
Net capital expenditures	**27,421**	**959**	**28,380**

	Three Months Ended June 30, 2010		
($ thousands)	Canada	United States	Combined
Petroleum and natural gas revenue, net of royalties	32,923	2,968	35,891
Earnings before income taxes	16,524	1,714	18,238
Net capital expenditures	34,139	232	34,371

	Six Months Ended June 30, 2010		
($ thousands)	Canada	United States	Combined
Petroleum and natural gas revenue, net of royalties	69,244	6,139	75,383
Earnings before income taxes	17,516	3,724	21,240
Net capital expenditures	52,094	512	52,606

	June 30, 2011		
($ thousands)	**Canada**	**United States**	**Combined**
Property, plant and equipment	**387,349**	**27,620**	**414,969**
Intangible exploration and evaluation assets and goodwill	**29,220**	**823**	**30,043**
Total assets	**439,967**	**32,608**	**472,575**

		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 before income tax

		Three Months Ended June 30, 2011	
($ thousands)	**Canada**	**United States**	**Combined**
Segment profit	**17,323**	**1,961**	**19,284**
Net finance expense	**(2,070)**	**(35)**	**(2,105)**
Earnings before income tax	**15,253**	**1,926**	**17,179**

		Six Months Ended June 30, 2011	
($ thousands)	**Canada**	**United States**	**Combined**
Segment profit	**7,181**	**3,547**	**10,728**
Net finance expense	**(4,643)**	**(70)**	**(4,713)**
Earnings before income tax	**2,538**	**3,477**	**6,015**

		Three Months Ended June 30, 2010	
($ thousands)	Canada	United States	Combined
Segment profit	18,440	1,747	20,187
Net finance expense	(1,916)	(33)	(1,949)
Earnings before income tax	16,524	1,714	18,238

		Six Months Ended June 30, 2010	
($ thousands)	Canada	United States	Combined
Segment profit	21,166	3,793	24,959
Net finance expense	(3,650)	(69)	(3,719)
Earnings before income tax	17,516	3,724	21,240

18. CASH DIVIDENDS

During the period, the Company declared dividends to the shareholders in the aggregate amount of $23.61 million (2010 – $25.17 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
April	April 30, 2011	May 16, 2011	$0.14
May	May 31, 2011	June 15, 2011	$0.14
June	June 30, 2011	July 15, 2011	$0.14

(1) The 2011 cash dividends include a non-cash equity issuance amount of $3.49 million (2010 – $0.74 million) for the Dividend Reinvestment Plan which commenced in April 2010.

19. SUBSEQUENT EVENT

Subsequent to the end of the second quarter, Zargon completed two Williston Basin property dispositions at Antler and Manor for total cash compensation of approximately $24.5 million. In aggregate, these two southeast Saskatchewan properties were producing 260 barrels of oil per day, and had included 7.8 thousand net acres of undeveloped land.

20. RECONCILIATIONS OF 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)

Reconciliation of consolidated balance sheet as at June 30, 2010:

($ thousands)	Notes	Canadian GAAP	Effect of Transition to IFRS	IFRS
ASSETS				
Trade and other receivables		22,599	–	22,599
Prepaid expenses and deposits		3,008	–	3,008
Derivatives		1,456	–	1,456
Deferred tax assets	(a)	423	(423)	–
Total current assets		27,486	(423)	27,063
Long term deposit		642	–	642
Derivatives		861	–	861
Property, plant and equipment, net	(b) (c) (i) (l)	452,465	(15,003)	437,462
Intangible exploration and evaluation assets	(b)	–	26,538	26,538
Goodwill		2,969	–	2,969
Deferred tax assets	(a)	25	423	448
		484,448	11,535	495,983
LIABILITIES				
Trade and other payables		29,204	–	29,204
Cash distributions payable		3,955	–	3,955
Derivatives		1,573	–	1,573
Deferred tax liabilities	(a)	391	(391)	–
Exchangeable shares	(f)	–	53,380	53,380
Total current liabilities		35,123	52,989	88,112
Long term debt		114,118	–	114,118
Derivatives		93	–	93
Unit-based compensation liability	(g)	–	6,457	6,457
Provisions	(j)	40,292	50,405	90,697
Deferred tax liabilities	(a) (e)	25,159	(12,922)	12,237
		214,785	96,929	311,714
EQUITY				
Unitholders' capital		194,622	–	194,622
Non-controlling interest – exchangeable shares	(f)	26,489	(26,489)	–
Accumulated other comprehensive income	(h)	–	301	301
Contributed surplus	(g)	5,881	(5,881)	–
Retained earnings/(deficit)	(p)	42,671	(53,325)	(10,654)
		269,663	(85,394)	184,269
		484,448	11,535	495,983

See accompanying explanatory notes.

Reconciliation of consolidated balance sheet 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 and equipment, net	(b) (c) (i) (l)	439,228	(27,109)	412,119
Intangible exploration and evaluation 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	(a) (e)	18,190	(13,320)	4,870
		224,452	40,096	264,548
EQUITY				
Shareholders' capital		240,805	(39,714)	201,091
Accumulated other comprehensive loss	(h)	–	(1,208)	(1,208)
Contributed surplus	(g)	6,391	1,424	7,815
Retained earnings	(m) (p)	–	–	–
		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 three months ended June 30, 2010:

($ thousands)	Notes	Canadian GAAP	Effect of Transition to IFRS	IFRS
Petroleum and natural gas sales		43,886	–	43,886
Unrealized risk management loss	(n)	6,990	(6,990)	–
Realized risk management loss	(n)	1,417	(1,417)	–
Royalties		(7,995)	–	(7,995)
PETROLEUM AND NATURAL GAS REVENUE		44,298	(8,407)	35,891
Gain on unrealized derivatives	(n)	–	6,990	6,990
Gain on realized derivatives	(n)	–	1,417	1,417
OTHER INCOME		–	8,407	8,407
		44,298	–	44,298
Production and operating expenses		11,512	–	11,512
Transportation expenses		296	–	296
Exploration and evaluation expenses	(b)	–	699	699
General and administrative expenses		4,337	–	4,337
Unrealized foreign exchange gain	(h)	14	(14)	–
Exchangeable shares revaluation	(f)	–	(4,081)	(4,081)
Gain on disposal of assets	(l)	–	(1,362)	(1,362)
Share-based compensation	(g)	365	(142)	223
Depletion, depreciation and amortization	(c)	16,763	(4,276)	12,487
EXPENSES		33,287	(9,176)	24,111
Interest and financing charges		1,173	–	1,173
Accretion of asset retirement obligations	(j)	874	(98)	776
FINANCE EXPENSES		2,047	(98)	1,949
EARNINGS BEFORE INCOME TAXES		8,964	9,274	18,238
Current tax expense		817	–	817
Deferred tax recovery	(e)	(1,584)	1,144	(440)
INCOME TAXES		(767)	1,144	377
NET EARNINGS FOR THE PERIOD		9,731	8,130	17,861
LESS NET EARNINGS ATTRIBUTED TO NON-CONTROLLING INTEREST	(f)	1,078	(1,078)	–
NET EARNINGS ATTRIBUTED TO ZARGON		8,653	9,208	17,861
OTHER COMPREHENSIVE INCOME				
Currency translation adjustment (net of $263 of tax)	(h)	–	665	665
OTHER COMPREHENSIVE INCOME FOR THE PERIOD		–	665	665
TOTAL COMPREHENSIVE INCOME FOR THE PERIOD		8,653	9,873	18,526

See accompanying explanatory notes.

Reconciliation of consolidated statement of earnings and comprehensive income for the six months ended June 30, 2010:

($ thousands)	Notes	Canadian GAAP	Effect of Transition to IFRS	IFRS
Petroleum and natural gas sales		92,342	–	92,342
Unrealized risk management gain	(n)	3,663	(3,663)	–
Realized risk management gain	(n)	2,597	(2,597)	–
Royalties		(16,959)	–	(16,959)
PETROLEUM AND NATURAL GAS REVENUE		81,643	(6,260)	75,383
Gain on unrealized derivatives	(n)	–	3,663	3,663
Gain on realized derivatives	(n)	–	2,597	2,597
OTHER INCOME		–	6,260	6,260
		81,643	–	81,643
Production and operating expenses		23,086	–	23,086
Transportation expenses		570	–	570
Exploration and evaluation expenses	(b)	–	1,204	1,204
General and administrative expenses		7,914	–	7,914
Unrealized foreign exchange gain	(h)	(12)	12	–
Exchangeable shares revaluation	(f)	–	–	–
Gain on disposal of assets	(l)	–	(1,362)	(1,362)
Share-based compensation	(g)	736	(64)	672
Depletion, depreciation and amortization	(c)	33,162	(8,562)	24,600
EXPENSES		65,456	(8,772)	56,684
Interest and financing charges		2,243	–	2,243
Accretion of asset retirement obligations	(j)	1,655	(179)	1,476
FINANCE EXPENSES		3,898	(179)	3,719
EARNINGS BEFORE INCOME TAXES		12,289	8,951	21,240
Current tax expense		1,565	–	1,565
Deferred tax recovery	(e)	(4,811)	2,274	(2,537)
INCOME TAXES		(3,246)	2,274	(972)
NET EARNINGS FOR THE PERIOD		15,535	6,677	22,212
LESS NET EARNINGS ATTRIBUTED TO NON-CONTROLLING INTEREST	(f)	1,727	(1,727)	–
NET EARNINGS ATTRIBUTED TO ZARGON		13,808	8,404	22,212
OTHER COMPREHENSIVE INCOME				
Currency translation adjustment (net of $85 of tax)	(h)	–	216	216
OTHER COMPREHENSIVE INCOME FOR THE PERIOD		–	216	216
TOTAL COMPREHENSIVE INCOME FOR THE PERIOD		13,808	8,620	22,428

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 $0.42 million and current deferred tax liabilities of $0.39 million at June 30, 2010 ($2.89 million and nil, respectively, 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 June 30, 2010 and December 31, 2010 resulting in a reduction in property, plant and equipment and retained earnings of $1.20 million and $2.81 million, respectively, and an increase in exploration and evaluation expenses for the six months and for the year of the same amounts. The increase to exploration and evaluation expense for the three months ended June 31, 2010 was $0.70 million.

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. An assessment of indicators of impairment was made at June 30, 2010 and it was determined that no indicators were present. 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 9.

(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. For the six months ended June 30, 2010, this resulted in increases to property, plant and equipment and retained earnings and a decrease to depletion expense of $8.56 million. The December 31, 2010 effect was increases in property, plant and equipment and retained earnings and a decrease to depletion expense of $17.21 million. The decrease in depletion expense for the three months ended June 31, 2010 was $4.28 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 result of all measurement differences, including the two discussed above, the Company recorded a decrease in the deferred tax liability of $12.92 million for the six months ended June 30, 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 (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 an 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 million as at January 1, 2010. The Company recorded no change in exchangeable shares for the six months ended June 30, 2010. The exchangeable share revaluation relating to the three month period ended June 30, 2010 resulted in recording a gain of $4.08 million in earnings.

(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 Payments" 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 decreased share-based compensation expense by $0.14 million and $0.06 million for the three and six months ended June 30, 2010, respectively.

(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 at January 1, 2010. Currency translation adjustments of $0.67 million and $0.22 million were recognized for the three and six months ended June 30, 2010, respectively, 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 2(c) 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 and evaluation and exploration assets by $5.40 million and $0.11 million, respectively, for the six months ended June 30, 2010. This increased property, plant and equipment and 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 recognize 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 and estimated the amount to be recognized in retained earnings by discounting the liability to the date at which the liability first arose. This further 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 $50.41 million for the six months ended June 30, 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, 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 three and six months ended June 30, 2010, the Company recognized a gain on disposals of $1.36 million under IFRS (nil under Canadian GAAP).

(m) 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.

(n) 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 "other income" section and renamed as "derivatives".

(o) 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 and 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.

(p) 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)

BOARD OF DIRECTORS

Craig H. Hansen
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

Craig H. Hansen
President and Chief Executive Officer

Charles L. Buckley
Vice President, Geosciences

Randy J. Doetzel
Vice President, Operations

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

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

STOCK EXCHANGE LISTING

Toronto Stock Exchange

Zargon Oil & Gas Ltd.
Common Shares
Trading Symbol: ZAR

TRANSFER AGENT

Valiant Trust Company
310, 606 – 4th Street S.W.
Calgary, Alberta T2P 1T1

BANKERS

The Toronto Dominion Bank
910, 333 – 7th Avenue S.W.
Calgary, Alberta T2P 2Z1

Canadian Imperial Bank of Commerce
9th Floor, Bankers Hall East
855 – 2nd Street S.W.
Calgary, Alberta T2P 2P2

The Bank of Nova Scotia
2000, 700 – 2nd Street S.W.
Calgary, Alberta T2P 2N7

LEGAL COUNSEL

Burnet, Duckworth & Palmer LLP
1400, 350 – 7th Avenue S.W.
Calgary, Alberta T2P 3N9

CONSULTING ENGINEERS

McDaniel & Associates Consultants Ltd.
2200, 255 – 5th Avenue S.W.
Calgary, Alberta T2P 3G6

AUDITORS

Ernst & Young LLP
1000, 440 – 2nd Avenue S.W.
Calgary, Alberta T2P 5E9

HEAD OFFICE

700, 333 – 5th Avenue S.W.
Calgary, Alberta T2P 3B6
Telephone: 403-264-9992
Fax: 403-265-3026
Email: zargon@zargon.ca

WEBSITE

www.zargon.ca