

### FINANCIAL AND OPERATING HIGHLIGHTS

(unaudited)	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	Percent Change	2014	2013	Percent Change
<b>Financial</b>						
<b>Income and Investments (\$ millions)</b>						
Gross petroleum and natural gas sales	40.86	40.59	1	81.12	77.67	4
Funds flow from operating activities	11.88	15.99	(26)	27.18	29.89	(9)
Cash flows from operating activities	10.03	14.68	(32)	24.89	27.14	(8)
Cash dividends (net of Dividend Reinvestment Plan)	5.42	5.01	8	10.84	9.76	11
Net earnings/(loss)	(2.02)	1.13	(279)	(1.85)	1.35	(237)
Net capital expenditures	13.37	2.42	452	28.85	18.61	55
<b>Per Share, Basic</b>						
Funds flow from operating activities (\$/share)	0.39	0.53	(26)	0.90	1.00	(10)
Cash flows from operating activities (\$/share)	0.33	0.49	(33)	0.83	0.91	(9)
Net earnings/(loss) (\$/share)	(0.07)	0.04	(275)	(0.06)	0.05	(220)
<b>Cash Dividends (\$/common share)</b>	<b>0.18</b>	0.18	–	<b>0.36</b>	0.36	–
<b>Balance Sheet at Period End (\$ millions)</b>						
Property and equipment				414.08	386.37	7
Exploration and evaluation assets				12.25	17.92	(32)
Long term bank debt				56.37	42.06	34
Convertible debentures at maturity				57.50	57.50	–
Shareholders' equity				161.75	190.08	(15)
<b>Total Common Shares Outstanding at Period End (millions)</b>				<b>30.13</b>	30.04	–
<b>Operating</b>						
<b>Average Daily Production</b>						
Oil and liquids (bbl/d)	4,096	4,930	(17)	4,208	5,021	(16)
Natural gas (mmcf/d)	14.77	14.77	–	14.41	14.99	(4)
Equivalent (boe/d)	6,558	7,392	(11)	6,610	7,519	(12)
<b>Average Selling Price (before the impact of financial risk management contracts)</b>						
Oil and liquids (\$/bbl)	93.26	80.44	16	89.92	75.97	18
Natural gas (\$/mcf)	4.54	3.35	36	4.85	3.18	53
<b>Wells Drilled, Net</b>	<b>8.0</b>	–	–	<b>11.7</b>	5.1	129
<b>Undeveloped Land at Period End (thousand net acres)</b>				<b>183</b>	300	(39)

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.

Funds flow from operating activities is an additional GAAP term that represents net earnings/(loss) 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.

Cash dividends are net of the Dividend Reinvestment Plan in 2013. The Dividend Reinvestment Plan was suspended September 2013.

## Production

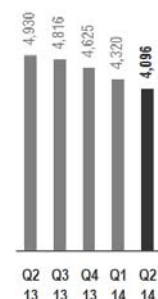
(boe/d)



## Oil and Liquids

### Production

(bbl/d)



## Natural Gas

### Production

(mmcf/d)



## Message to Shareholders <sup>(1)</sup>

Zargon Oil & Gas Ltd. has released its financial and operating results for the second quarter of 2014 that is highlighted by encouraging facility operations and injection performance for the Little Bow Alkaline Surfactant Polymer (“ASP”) enhanced oil recovery project.

Specific financial and operating highlights in the second quarter of 2014 include:

- Funds flow from operating activities of \$11.9 million were 22 percent lower than the \$15.3 million recorded in the prior quarter due to a combination of higher effective royalty rates, additional operating costs relating to now operational ASP facilities and increased realized hedge losses. Funds flow from operating activities for the 2014 second quarter included reductions of \$3.7 million of realized hedge losses and \$0.5 million of asset retirement expenses.
- Second quarter 2014 production averaged 4,096 barrels of oil and liquids per day, a five percent decrease from the preceding quarter and second quarter 2014 natural gas production averaged 14.8 million cubic feet per day, a five percent increase from the preceding quarter. Total production averaged 6,558 barrels of oil equivalent per day, a two percent decrease from the preceding quarter. During the quarter, oil and liquids production represented 62 percent of total production based on a 6:1 equivalent basis.
- Three monthly cash dividends of \$0.06 per common share were declared in the second quarter of 2014 for a total of \$5.4 million. These cash dividends were equivalent to a payout ratio of 46 percent of funds flow from operating activities.
- Second quarter 2014 exploration and development capital expenditures (excluding property acquisitions and dispositions) were \$16.4 million and included \$4.9 million of expenditures related to the Little Bow ASP phase 1 project development and chemical costs. In the quarter, Zargon drilled 8.0 gross wells (8.0 net wells) that resulted in 8.0 net oil wells and completed four property dispositions and one property acquisition which realized \$3.2 million of net proceeds.
- On June 13, 2014, Zargon amended and renewed its syndicated committed credit facilities of \$150 million, a reduction from the previous facilities of \$165 million. Zargon’s June 30, 2014 debt, net of working capital (excluding unrealized derivative assets/liabilities) and using the full future face value of the convertible debenture of \$57.5 million, was \$128.9 million and is approximately 2.4 times annualized 2014 first half funds flow from operating activities. At June 30, 2014, Zargon had \$75 million of available credit facilities remaining on its \$150 million borrowing base.
- Subsequent to quarter end, Alberta Energy announced revisions to the Enhanced Oil Recovery (“EOR”) royalty program which effectively brings the Alberta conventional oil EOR royalties more in line with existing Alberta oil sands (in-situ) and Saskatchewan conventional oil EOR royalty programs. These revisions have a significant positive impact on the economics of Zargon’s ASP enhanced oil recovery project at Little Bow in Southern Alberta (refer to Zargon’s July 28, 2014 news release which is available at [www.zargon.ca](http://www.zargon.ca)).

## Little Bow Alkaline Surfactant Polymer (“ASP”) Project <sup>(1)</sup>

Zargon commenced chemical injections at the Little Bow ASP enhanced oil recovery project in March 2014. This ASP project entails the injection of large volumes of a dilute chemical solution into a partially depleted oil reservoir to recover incremental oil reserves. Since the commencement of ASP injection more than one million barrels of ASP solution have been injected into the phase 1 area of the Little Bow Mannville I Pool, at an average injection rate of 102 percent of design capacity. Encouragingly, pattern injection rates are balanced and are meeting or exceeding reservoir models, and to date we have observed no evidence of ASP fluid breakthrough and the related oil production volumes. We interpret the delay in oil production volumes positively, as it provides us supporting evidence that the ASP injections are not bypassing the reservoir in a short circuited path from injectors to producers but instead are forming oil banks that will be conformably swept to producers over the multi-year life of the project.

The total cost to construct and commission phase 1 of the Little Bow ASP project was \$50.4 million of which \$1.8 million was spent in the 2014 second quarter. Phase 2 construction and implementation costs are expected to be \$12 million and are scheduled to be equally divided between the second half of 2015 and the first half of 2016. The estimated total phase 1 and 2 chemical cost for the 2014-2019 chemical injection period will be capitalized and is estimated at \$81 million (as spent dollars) of which \$1.4 and \$3.0 million have been spent in the first and second quarters of 2014, respectively.

Phase 1 of the Little Bow ASP project is now expected to commence initial production in the 2014 fourth quarter and increase to a 2014 year end rate of 150 barrels of oil per day. Incremental production is expected to exceed 700 barrels of oil per day in 2015 and then increase to 1,550 barrels of oil per day in 2016, when phase 2 injection begins.

Including the additional phase 3 and 4 working interests acquired in the second quarter, follow-on capital expenditures of \$105 million (including chemical costs) for phases 3 and 4 of the Little Bow ASP project are expected to yield an additional 4.7 million barrels of incremental oil. Zargon's combined Little Bow project (phases 1 through 4) total production is expected to stabilize at 2,300 barrels of oil per day in the 2020 through 2025 period. For further information regarding the Little Bow ASP project, please refer to our updated corporate presentation, which is available at [www.zargon.ca](http://www.zargon.ca).

#### **Other Field Activities <sup>(1)</sup>**

In addition to the second quarter's \$4.9 million of ASP phase 1 development and chemical capital expenditures, Zargon executed an \$11.5 million capital program in the 2014 second quarter on conventional oil exploitation assets. This program included the drilling of 8.0 net oil exploitation wells at the Bellshill Lake (5), Taber (2) and Williston Basin (1) properties. Zargon's remaining five (non-ASP) oil exploitation projects are (or will be) pressure supported by water injections or natural reservoir aquifers and consequently provide long-life low-decline oil volumes. In aggregate, these properties bring more than 60 horizontal locations that can be methodically drilled to maintain stable non-ASP oil production volumes for many years.

During the interim period, until ASP production volumes and related cash flows arrive, our non-ASP capital programs will be muted. For the remainder of the year, Zargon is planning a 5.0 net well drilling program at the Taber Sunburst (2) and Williston Basin Mississippian (3) properties.

#### **Property Dispositions Update <sup>(1)</sup>**

Zargon remains focused on consolidating our property footprint on higher netback oil exploitation assets. During the second quarter, \$6.4 million of property dispositions were concluded that were partially offset by \$3.2 million of property acquisitions. Subsequent to quarter end, an additional \$0.9 million of property dispositions have been concluded. The disposition properties were primarily non-strategic West Central Alberta natural gas assets that were partially offset by acquired Little Bow assets that take our interests in phases 3 and 4 of the Little Bow ASP project to more than 97 percent. In aggregate, the net effect of these eight completed transactions is the sale of 40 barrels of oil per day and 2.5 million cubic feet of natural gas per day (438 barrels of oil equivalent per day) for \$4.1 million of net proceeds.

#### **2014 & 2015 Outlook <sup>(1)</sup>**

Zargon's 2014 total capital budget continues to be set at \$52 million (before dispositions) of which approximately \$18 million remains to be spent in the second half of the year. The 2014 ASP capital budget is now set at \$19 million and includes \$8 million for the completed phase 1 development costs and \$11 million of chemical costs of which \$7 million is forecast to be spent in the second half of the year. For 2015, our preliminary \$19 million ASP capital budget includes \$13 million of chemical costs and \$6 million of phase 2 development costs.

Zargon's 2014 non-ASP field capital budget has been set at \$33 million (before dispositions) of which approximately \$12 million will be spent in the remaining two quarters. For 2015, the preliminary \$25 million non-ASP field capital budget will focus on existing oil exploitation projects. As additional corporate cash flows are realized, incremental capital may be allocated to these non-ASP oil exploitation properties.

Finally, Zargon's 2014 net property disposition program had been set at \$5 million. Including the \$0.9 million of property dispositions that have been concluded after quarter end, Zargon's 2014 year-to-date property disposition program has realized net proceeds of \$5.6 million. Additional natural gas property dispositions are anticipated.

Also, Zargon has entered into a significant oil hedging program to provide a measure of stability and predictability to cash flows as we wait for the ASP production volumes to ramp up. For the remainder of 2014, Zargon has hedged 2,600 barrels per day at \$90.92 US/bbl WTI and 400 barrels per day at \$99.60 Cdn/bbl WTI, while for the first half of 2015 an average of 1,400 barrels per day is hedged at \$93.68 US/bbl WTI.

#### **Production Guidance <sup>(1)</sup>**

In the May 14, 2014 first quarter results press release, Zargon provided second quarter 2014 oil production rate guidance of 4,200 barrels of oil and liquids per day. Actual second quarter volumes were 4,096 barrels of oil and liquids per day and were two percent less than guidance. The press release also set Zargon's second quarter 2014 natural gas production guidance of 14.0 million cubic feet per day. Second quarter actual volumes were 14.8 million cubic feet per day and exceeded guidance by six percent.

Oil and liquids production for the 2014 third quarter is set at 4,100 barrels of oil per day and includes the impact of the second quarter drilling program plus the completed property dispositions. Third quarter natural gas production guidance is set at 12.0 million cubic feet per day. For the remainder of the year, production volumes will depend on the magnitude and timing of our remaining property dispositions.

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

## MANAGEMENT'S DISCUSSION AND ANALYSIS

Management's discussion and analysis ("MD&A") is a review of Zargon Oil & Gas Ltd.'s 2014 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, 2014 and the audited consolidated financial statements and related notes for the year ended December 31, 2013. The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), 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, natural gas is converted to a barrel of oil equivalent ("Boe") using six thousand cubic feet of gas to one barrel of oil. In certain circumstances, natural gas liquid volumes have been converted to a thousand cubic feet equivalent ("Mcf") on the basis of one barrel of natural gas liquids to six thousand cubic feet of gas. Boes and Mcfes may be misleading, particularly if used in isolation. A conversion ratio of one barrel to six thousand cubic feet of natural gas is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Given that the value ratio based on the current price of crude oil as compared to natural gas is significantly different from the energy equivalency of 6:1, utilizing a conversion ratio on a 6:1 basis may be misleading as an indication of value.

The following are descriptions of additional 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 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.

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

- The Company 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 plus the full future face value of the convertible debenture of \$57.50 million and any working capital deficit excluding unrealized derivative assets/liabilities.
- 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, operating expenses per boe and transportation expenses 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, interest on the convertible debenture per boe, asset retirement expenditures per boe, cash portion of exploration and evaluation, 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.

*Forward-Looking Statements* – This document offers our assessment of Zargon’s future plans and operations as at August 11, 2014, and contains forward-looking statements including:

- our expectations for our plans with respect to our Little Bow ASP project and the results therefrom referred to under the headings “Message to Shareholders”, “Little Bow Alkaline Surfactant Polymer (“ASP”) Project”, “Property Dispositions Update”, “2014 & 2015 Outlook”, “Production Guidance”, “Royalties”, “Operating Expenses and Transportation Expenses” and “Outlook”;
- our expectations for our plans with respect to our budgeted 2014 property dispositions referred to under the headings “Message to Shareholders”, “Property Dispositions Update”, “2014 & 2015 Outlook” and “Production Guidance”;
- our expectations for our budgeted 2014 conventional oil exploitation assets capital program referred to under the headings “Message to Shareholders”, “Other Field Activities”, “2014 & 2015 Outlook” and “Production Guidance”;
- our expectations for our 2014 and 2015 hedges referred to under the heading “2014 & 2015 Outlook”;
- our expectations for royalties referred to under the heading “Financial & Operating Results”;
- our expectations for operating expenses and transportation expenses referred to under the heading “Financial & Operating Results”;
- our expectations for general and administrative expenses referred to under the heading “Financial & Operating Results”;
- our dividend policy referred to under the headings “Message to Shareholders” and “Liquidity and Capital Resources”;
- our expected sources of funds for dividend referred to under the headings “Liquidity and Capital Resources” and “Outlook”;
- our expectations for production referred to under the heading “Production Guidance”; and
- our expected sources of funds for capital expenditures referred to under the heading “Liquidity and Capital Resources”.

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](http://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 (including ASP); 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 11, 2014.

## FINANCIAL & OPERATING RESULTS

### Petroleum and Natural Gas Sales

(\$ millions)	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	Percent Change	2014	2013	Percent Change
Petroleum sales	<b>34.76</b>	36.08	(4)	<b>68.48</b>	69.04	(1)
Natural gas sales	<b>6.10</b>	4.51	35	<b>12.64</b>	8.63	46
Petroleum and natural gas sales	<b>40.86</b>	40.59	1	<b>81.12</b>	77.67	4

Second quarter 2014 gross petroleum and natural gas sales of \$40.86 million were one percent above the \$40.59 million in the second quarter of 2013 due to higher oil and natural gas prices partially offset by lower production.

Second quarter 2014 realized oil and liquids field prices averaged \$93.26 per barrel before the impact of financial risk management contracts and were 16 percent higher than the \$80.44 per barrel recorded in the 2013 second quarter. Zargon's crude oil field price differential from the Edmonton par price decreased to \$11.93 per barrel in the second quarter of 2014 compared to \$12.15 per barrel in the second quarter of 2013. Natural gas field prices received averaged \$4.54 per thousand cubic feet in the second quarter of 2014, a 36 percent increase from the 2013 second quarter prices.

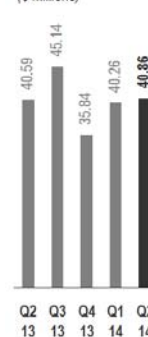
### Pricing

Average for the period	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	Percent Change	2014	2013	Percent Change
Natural Gas:						
NYMEX average daily spot price (\$US/mmbtu)	<b>4.59</b>	4.02	14	<b>4.89</b>	3.73	31
AECO average daily spot price (\$Cdn/mmbtu)	<b>4.69</b>	3.54	32	<b>5.20</b>	3.36	55
Zargon realized field price before the impact of financial risk management contracts (\$Cdn/mcf) <sup>(1)</sup>	<b>4.54</b>	3.35	36	<b>4.85</b>	3.18	53
Zargon realized field price before the impact of physical and financial risk management contracts (\$Cdn/mcf) <sup>(1)</sup>	<b>4.54</b>	3.35	36	<b>4.99</b>	3.18	57
Zargon realized field price after the impact of physical and financial risk management contracts (\$Cdn/mcf) <sup>(1)</sup>	<b>4.09</b>	3.35	22	<b>4.37</b>	3.18	37
Zargon realized natural gas field price differential <sup>(1)(2)</sup>	<b>0.15</b>	0.19		<b>0.35</b>	0.18	
Zargon realized natural gas field price differential before the impact of physical and financial risk management contracts (\$Cdn/mcf)	<b>0.15</b>	0.19		<b>0.21</b>	0.18	

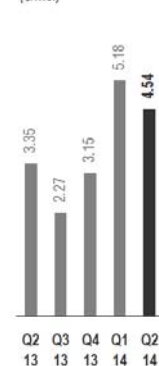
(1) Zargon was not subject to any natural gas financial risk management contracts for the first six months of 2013.

(2) Calculated as Zargon's realized field price (\$Cdn/mcf) as compared to AECO average daily spot price (\$Cdn/mmbtu).

Petroleum and Natural Gas Revenue (\$ millions)



Natural Gas Prices (\$/mcf)



## Oil and Liquids

### Prices

(\$/bbl)



Average for the period	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	Percent Change	2014	2013	Percent Change
<b>Crude Oil:</b>						
WTI (\$US/bbl)	<b>102.99</b>	94.22	9	<b>100.84</b>	94.30	7
Edmonton par price (\$Cdn/bbl)	<b>105.19</b>	92.59	14	<b>102.49</b>	90.40	13
Zargon realized field price before the impact of financial risk management contracts (\$Cdn/bbl)	<b>93.26</b>	80.44	16	<b>89.92</b>	75.97	18
Zargon realized field price after the impact of financial risk management contracts (\$Cdn/bbl)	<b>84.98</b>	82.68	3	<b>83.75</b>	78.54	7
Zargon realized oil field price differential <sup>(1)</sup>	<b>11.93</b>	12.15		<b>12.57</b>	14.43	

(1) 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).

### Volumes

Oil and liquids production volumes during the 2014 second quarter were 4,096 barrels per day, a 17 percent decrease from the 2013 second quarter rate of 4,930 barrels per day. The production decrease is due to natural occurring production declines and property dispositions that occurred in the second half of 2013 and first half of 2014. Natural gas production volumes in the 2014 second quarter of 14.77 million cubic feet per day were essentially unchanged from the 2013 second quarter.

### Production by Core Area

Three Months Ended June 30,	2014			2013		
	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	1,120	11.72	3,074	1,256	11.54	3,179
Alberta Plains South	1,275	2.63	1,713	1,695	2.90	2,178
Williston Basin	1,701	0.42	1,771	1,979	0.33	2,035
	<b>4,096</b>	<b>14.77</b>	<b>6,558</b>	4,930	14.77	7,392

Six Months Ended June 30,	2014			2013		
	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	1,145	11.36	3,038	1,301	11.76	3,261
Alberta Plains South	1,321	2.63	1,760	1,722	2.87	2,200
Williston Basin	1,742	0.42	1,812	1,998	0.36	2,058
	<b>4,208</b>	<b>14.41</b>	<b>6,610</b>	5,021	14.99	7,519

### Risk Management Contracts

Zargon's commodity price risk management policy, which is approved by the Board of Directors, allows for the sale of up to a certain percentage of its estimated before royalty production volumes for each commodity up to a 30 month period. Zargon's policy permits for the sale of up to a 70 percent maximum of estimated before royalty production volumes for oil for the first 12 months, a 60 percent maximum on the following 12 months and a 50 percent maximum on the final six months. Zargon's policy permits for the sale of up to a 60 percent maximum of estimated before royalty production volumes for natural gas for the first 24 months and a 50 percent maximum on the final six months. The commodity price risk management policy is maintained for the purpose of reducing volatility in the financial results and to stabilize and hedge further cash flows against an unpredictable commodity price environment, with an emphasis on protecting



downside risk. Because our risk management strategy is protective in nature and is designed to guard the Company against extreme effects on funds flow from sudden falls in prices and revenue, upward price spikes tend to produce overall risk management losses.

Zargon also has two five year interest rate swaps on a total of \$40 million of borrowing with an average effective interest rate of 1.69 percent plus stamping fee (currently at 2.00 percent) and two physical electricity hedges.

For accounting purposes, an unrealized gain or loss from forward sale commodity contracts and interest rate swaps 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 consolidated statement of earnings and their fair value is reflected in "derivative assets" or "derivative liabilities" on the consolidated balance sheets.

In the 2014 second quarter, relatively lower contract prices versus WTI oil prices resulted in a net realized loss on derivatives of \$3.73 million compared to a \$0.96 million net realized gain in the second quarter of 2013.

The unrealized loss on derivatives of \$1.77 million in the second quarter of 2014 was comprised of oil contract losses of \$2.72 million, a natural gas contract gain of \$0.92 million and an interest rate swap gain of \$0.03 million, compared to a net \$2.08 million gain in the second quarter of 2013. These non-cash unrealized derivative gains or losses are generated by the change over the reporting period in the mark-to-market valuation of Zargon's risk management contracts. Commodity price volatility has resulted in significant fluctuations in the mark-to-market amount of unrealized derivative assets and liabilities. Zargon's commodity risk management positions are described in Notes 11 and 12 to the unaudited interim consolidated financial statements.

### Royalties

(\$ millions)	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	Percent Change	2014	2013	Percent Change
Royalties	<b>8.19</b>	7.07	16	<b>14.92</b>	13.74	9
Percentage of revenue	<b>20.1%</b>	17.4%		<b>18.4%</b>	17.7%	

Royalties are inclusive of the Saskatchewan Resource Surcharge ("SRC"). The variations in royalty rates generally track changes in production and volumes. Second quarter of 2014 royalties were 20.1 percent of gross sales compared to 17.4 percent in the second quarter of 2013. Looking forward, we anticipate a 19 percent effective royalty rate until significantly lower royalty ASP production commences.

### Operating Expenses and Transportation Expenses

(\$ millions)	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	Percent Change	2014	2013	Percent Change
Operating expenses	<b>11.38</b>	12.17	(6)	<b>21.60</b>	24.06	(10)
Transportation expenses	<b>0.38</b>	0.45	(16)	<b>0.89</b>	0.90	(1)
Total expenses	<b>11.76</b>	12.62	(7)	<b>22.49</b>	24.96	(10)
Total expenses (\$/boe)	<b>19.70</b>	18.76	5	<b>18.79</b>	18.34	2

Compared to the prior year's second quarter, operating expenses and transportation expenses in the 2014 second quarter were down on a total dollar basis but increased on a per barrel of oil equivalent basis. Commencing in the second quarter, the operating costs included the base expenditures required to operate the Little Bow ASP facility. Looking forward, we expect total operating and transportation expenses to remain at the \$20 per barrel of oil equivalent level, until the significantly lower incremental cost ASP production commences.

## Operating Netbacks

Three Months Ended June 30,	2014		2013	
	Oil and Liquids (\$/bbl)	Natural Gas (\$/mcf)	Oil and Liquids (\$/bbl)	Natural Gas (\$/mcf)
Sales	93.26	4.54	80.44	3.35
Royalties	(20.46)	(0.42)	(14.61)	(0.38)
Realized gain/(loss) on derivatives	(8.28)	(0.45)	2.24	–
Operating expenses	(22.60)	(2.20)	(20.58)	(2.19)
Transportation expenses	(1.01)	–	(1.00)	–
<b>Operating netbacks</b>	<b>40.91</b>	<b>1.47</b>	<b>46.49</b>	<b>0.78</b>

Six Months Ended June 30,	2014		2013	
	Oil and Liquids (\$/bbl)	Natural Gas (\$/mcf)	Oil and Liquids (\$/bbl)	Natural Gas (\$/mcf)
Sales	89.92	4.85	75.97	3.18
Royalties	(17.69)	(0.55)	(14.00)	(0.38)
Realized gain/(loss) on derivatives	(6.17)	(0.48)	2.57	–
Operating expenses	(20.97)	(2.16)	(19.83)	(2.23)
Transportation expenses	(1.16)	–	(0.99)	–
<b>Operating netbacks</b>	<b>43.93</b>	<b>1.66</b>	<b>43.72</b>	<b>0.57</b>

## General & Administrative (“G&A”) Expenses

(\$ millions)	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	Percent Change	2014	2013	Percent Change
G&A expenses	3.03	3.04	–	6.00	5.95	1
G&A expenses (\$/boe)	5.08	4.51	13	5.01	4.37	15

G&A expenses per barrel of oil equivalent were higher in the second quarter of 2014 primarily due to relatively stable costs and lower production volumes. In the long run, we will target G&A expenses, exclusive of transaction costs, of \$4.75 per barrel of oil equivalent, although in the short term higher costs will be recorded as we continue to sell non-strategic properties and then make the corresponding adjustments to our organizational structure.

## Transaction Costs

Transaction costs for the 2014 second quarter were \$0.15 million compared to \$0.10 million in the second quarter of 2013 and relate to property dispositions in the quarter.

## Interest and Financing Charges on Long Term Bank Debt

On June 13, 2014, Zargon amended and renewed its syndicated committed credit facilities of \$150 million, a reduction from the previous facilities of \$165 million. This reduction is a direct result of the sale of \$24.48 million (net) of properties during the last four quarters. The next renewal date is June 24, 2015, with a semi-annual review taking place in the fall of 2014. These facilities continue to be available for general corporate purposes and 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 2014 second quarter were \$0.68 million, an eight percent increase from \$0.63 million in the second quarter of 2013. The increase in interest and financing charges resulted from higher average borrowing levels partially offset by a lower effective interest rate compared to the second quarter of 2013.

### Interest on Convertible Debentures

Zargon has borrowings through its convertible debentures, which were issued in May 2012 and mature on June 30, 2017. Interest is payable semi-annually at a rate of six percent, calculated on the gross proceeds of \$57.50 million. Interest charges of \$0.86 million in the second quarter of 2014 were essentially unchanged compared to the second quarter of 2013.

### Current Income Taxes

Current income taxes for the 2014 second quarter were \$0.07 million, and relate to the US operations. When compared to the 2013 second quarter, current income taxes decreased by \$0.10 million. Total corporate tax pools as at June 30, 2014 are approximately \$311 million, which is essentially unchanged from the comparable \$310 million of tax pools available to Zargon at December 31, 2013.

### Corporate Netbacks

(\$/boe)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Petroleum and natural gas sales	<b>68.46</b>	60.34	<b>67.81</b>	57.07
Royalties	<b>(13.73)</b>	(10.51)	<b>(12.47)</b>	(10.09)
Realized gain/(loss) on derivatives	<b>(6.25)</b>	1.43	<b>(5.05)</b>	1.64
Operating expenses	<b>(19.07)</b>	(18.10)	<b>(18.05)</b>	(17.68)
Transportation expenses	<b>(0.63)</b>	(0.66)	<b>(0.74)</b>	(0.66)
Operating netbacks	<b>28.78</b>	32.50	<b>31.50</b>	30.28
General and administrative expenses	<b>(5.08)</b>	(4.51)	<b>(5.01)</b>	(4.37)
Transaction costs	<b>(0.25)</b>	(0.14)	<b>(0.16)</b>	(0.07)
Interest and financing charges	<b>(1.13)</b>	(0.93)	<b>(1.07)</b>	(0.88)
Interest on convertible debentures	<b>(1.44)</b>	(1.29)	<b>(1.44)</b>	(1.27)
Asset retirement expenditures	<b>(0.86)</b>	(1.60)	<b>(0.99)</b>	(1.48)
Current income taxes	<b>(0.12)</b>	(0.26)	<b>(0.12)</b>	(0.25)
Funds flow netbacks	<b>19.90</b>	23.77	<b>22.71</b>	21.96

### Depletion and Depreciation Expense

Depletion and depreciation expense for the second quarter of 2014 increased seven percent to \$11.90 million compared to \$11.09 million in the second quarter of 2013. On a per barrel of oil equivalent basis, the depletion and depreciation rates were \$19.95 and \$16.49 for the second quarter of 2014 and the second quarter of 2013, respectively. When compared to the second quarter of 2013, the increased depletion expense is primarily due to the inclusion of the ASP facility construction costs and reserves in the depletion calculation as the facility costs were not depleted during the construction phase. The 2013 calendar year depletion and depreciation rate was \$16.64 per barrel of oil equivalent.

Funds Flow  
Netbacks  
(\$/boe)



Funds Flow  
from Operating  
Activities  
(\$ millions)



### Accretion of Asset Retirement Obligations and Convertible Debentures

The accretion expense of asset retirement obligations for the second quarter of 2014 was \$1.07 million, a 49 percent increase from the second quarter of 2013 and resulted from the change in discount rate from 2.50% to 3.25% and estimated liability at December 31, 2013. Year-over-year adjustments are due to changes in the estimated future liability for asset retirement obligations resulting from changes in cost assumptions and adjustments in Zargon's well count due to drilling programs and property acquisitions or dispositions.

The debt portion of Zargon's convertible debenture is also accreted over its term, up to the total maturity value of \$57.50 million. Accretion on the convertible debenture for the 2014 second quarter was \$0.30 million.

### Shared-based Compensation

Expensing of share-based compensation in the second quarter of 2014 totalled \$0.55 million, which was higher than the \$0.50 million incurred in the second quarter of 2013 due to a higher black scholes value of the 2014 grants, including the impact of forfeitures.

### Unrealized Foreign Exchange

The Company had an unrealized foreign exchange gain of \$0.01 million during the second quarter of 2014 compared to a gain of \$0.09 million in the 2013 second quarter. Gains and losses result from transactions in US dollars when they are translated into Canadian dollars. The volatility in the US/Cdn dollar creates non-cash translation gains/losses.

### Gain on Disposal of Assets

During the second quarter of 2014, Zargon closed several dispositions of assets located in northwest and southern Alberta. Zargon reported a gain of \$1.26 million on the net disposal of assets.

### Exploration and Evaluation Expenses

Non-cash exploration and evaluation expenses for the 2014 second quarter of \$0.66 million compared to second quarter of 2013 expenses of \$1.46 million. Exploration and evaluation expenses are primarily related to undeveloped land expiries. The 2014 second quarter exploration and evaluation expense related to expiries in west central and northern Alberta.

### Deferred Tax

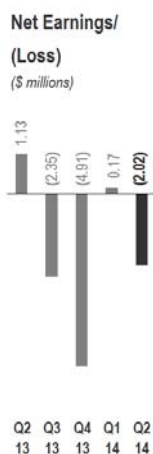
The deferred tax recovery for the second quarter of 2014 was \$0.57 million compared to a recovery of \$0.39 million in the second quarter of 2013. The increase in deferred tax recovery is primarily a result of a net loss in the quarter.

### Funds Flow from Operating Activities

Funds flow from operating activities in the 2014 second quarter of \$11.88 million was \$4.11 million, or 26 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 increased losses on realized derivatives which was partially offset by higher oil and natural gas prices and lower operating expenses.

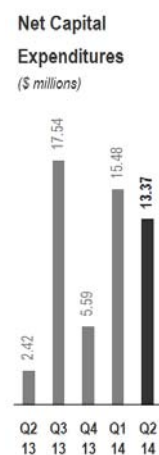
### Net Earnings/(Loss)

A net loss of \$2.02 million for the 2014 second quarter was down \$3.15 million from the \$1.13 million of net earnings in the 2013 second quarter, largely due to increased losses on realized and unrealized derivatives. The net earnings/(loss) 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 derivative gain/(loss), land expiries, property disposition gain/(loss) and deferred taxes. On a per diluted share basis, the second quarter 2014 net loss was \$0.07, compared to net earnings of \$0.04 for the 2013 second quarter.



## Capital Expenditures

(\$ millions)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Undeveloped land	0.75	1.12	1.63	1.91
Geological and geophysical (seismic)	0.57	0.65	0.71	0.87
Drilling and completion of wells	5.88	1.78	10.21	9.06
Well equipment and facilities	4.37	3.10	8.49	9.08
ASP phase 1 development costs	1.84	7.30	7.90	12.31
ASP chemical costs	3.02	–	4.41	–
Exploration and development	16.43	13.95	33.35	33.23
Property acquisitions	3.19	0.09	3.26	0.27
Property dispositions	(6.39)	(11.63)	(7.92)	(14.90)
Net property dispositions	(3.20)	(11.54)	(4.66)	(14.63)
Total net capital expenditures excluding administrative assets	13.23	2.41	28.69	18.60
Administrative assets	0.14	0.01	0.16	0.01
Total net capital expenditures	13.37	2.42	28.85	18.61



## LIQUIDITY AND CAPITAL RESOURCES

Total net capital expenditures (including net property dispositions) totalled \$13.37 million in the second quarter of 2014 and were 452 percent higher than the same period in 2013. Field expenditures of \$16.43 million for the second quarter of 2014 were 18 percent higher than the 2013 second quarter. The second quarter 2014 field capital expenditures (excluding net property dispositions) were allocated to Alberta Plains North - \$4.56 million, Alberta Plains South - \$7.91 million and Williston Basin - \$3.96 million and included the drilling of 8.0 net wells, up from the nil wells drilled in the second quarter of 2013.

Included in the Alberta Plains South capital expenditures is the \$4.86 million incurred on the Little Bow ASP project. Of the total ASP amount, \$1.84 million was spent on phase 1 development costs while \$3.02 million was spent on chemical costs for the facility.

Funds flow from operating activities in the 2014 second quarter of \$11.88 million and proceeds from the sale of properties of \$6.39 million were used to partially fund the capital program and cash dividends to shareholders.

At June 30, 2014, the Company's combined debt net of working capital (excluding unrealized derivative assets/liabilities) was \$128.88 million, which compares to \$116.24 million of net debt at the end of December 31, 2013. The increase in net debt was due to Zargon's 2014 second quarter capital expenditure program. The \$128.88 million debt net of working capital consists of the \$57.50 million of convertible unsecured subordinate debentures and the remaining portion of bank debt.

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

(\$ millions)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Cash flows from operating activities	10.03	14.68	24.89	27.14
Net earnings/(loss)	(2.02)	1.13	(1.85)	1.35
Actual cash dividends paid or payable relating to the period <sup>(1)</sup>	(5.42)	(5.01)	(10.84)	(9.76)
Excess of cash flows from operating activities over cash dividends paid	4.61	9.67	14.05	17.38
Excess (shortfall) of net earnings over cash dividends paid	(7.44)	(3.88)	(12.69)	(8.41)

(1) Cash dividends represent the cash portion only and do not include common shares issued through Zargon's Dividend Reinvestment Plan which was suspended September 2013.

During the first half of 2014, Zargon maintained a monthly dividend of \$0.06 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 petroleum and natural gas company, Zargon's reserve base is depleted by production and Zargon, therefore, relies on ongoing exploration, development, exploitation and acquisition activities to replace reserves and to offset production declines. The success of these capital programs, along with commodity price fluctuations and the Company's ability to manage costs, are the main factors influencing the sustainability of the Company's dividends.

For the three months ended June 30, 2014, cash flows from operating activities (after changes in non-cash working capital) of \$10.03 million exceeded cash dividends of \$5.42 million. Similarly, for the three months ended June 30, 2013, cash flows from operating activities (after changes in non-cash working capital) of \$14.68 million exceeded cash dividends of \$5.01 million.

For the three months ended June 30, 2014, a net loss of \$2.02 million was exceeded by cash dividends of \$5.42 million. The net loss includes significant non-cash charges of \$14.41 million for the 2014 second quarter that does not impact cash flow. For the three months ended June 30, 2013, net earnings of \$1.13 million were exceeded by cash dividends of \$5.01 million. 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, 2014, cash dividends and net capital expenditures totalled \$18.79 million, which was \$8.76 million higher than the cash flows from operating activities (after changes in non-cash working capital) of \$10.03 million. For the quarter ended June 30, 2013, cash dividends and net capital expenditures totalled \$7.43 million, which was \$7.25 million lower than the cash flows from operating activities (after changes in non-cash working capital) of \$14.68 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.

Cash Flows from Operating Activities  
(\$ millions)



At August 11, 2014, Zargon Oil & Gas Ltd. had 30.134 million common shares outstanding. Pursuant to the share award and common share rights incentive plans, there are currently an additional 0.956 million common share incentive rights issued and outstanding.

### Capital Sources and Uses

(\$ millions)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Funds flow from operating activities	<b>11.88</b>	15.99	<b>27.18</b>	29.89
Change in long term bank debt	<b>5.82</b>	(1.96)	<b>16.40</b>	6.33
Cash dividends to shareholders <sup>(1)</sup>	<b>(5.42)</b>	(5.01)	<b>(10.84)</b>	(9.76)
Changes in working capital and other	<b>1.09</b>	(6.60)	<b>(3.89)</b>	(7.85)
<b>Total capital sources</b>	<b>13.37</b>	2.42	<b>28.85</b>	18.61

(1) Cash dividends represent the cash portion only and do not include common shares issued through Zargon's Dividend Reinvestment Plan which was suspended September 2013.

### CHANGES IN ACCOUNTING POLICIES

The Company's changes in accounting policies are discussed in Note 3 to the Financial Statements.

### FUTURE CHANGES IN ACCOUNTING POLICIES

The Company's future changes in accounting policies are discussed in Note 3 to the Financial Statements.

### MANAGEMENT AND FINANCIAL REPORTING SYSTEMS

Zargon is required to comply with National Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings", otherwise referred to as Canadian SOX ("C-Sox"). The 2014 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 2014.

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. Zargon uses the 1992 Committee of Sponsoring Organizations of the Treadway Commission ("COSO") Framework as the Company has not yet adopted the 2013 COSO Framework.

### OUTLOOK

With a promising portfolio of long-life oil exploitation projects, Zargon is well positioned to meet its value-creating and dividend generating objectives through 2014 and beyond. In particular, Zargon's Little Bow ASP enhanced oil recovery project has the potential to provide significant oil production volume growth throughout the remainder of the decade.

## SUMMARY OF QUARTERLY RESULTS

	2014	
	Q1	Q2
Petroleum and natural gas sales (\$ millions)	40.26	<b>40.86</b>
Net earnings/(loss) (\$ millions)	0.17	<b>(2.02)</b>
Net earnings/(loss) per diluted share (\$)	0.01	<b>(0.07)</b>
Funds flow from operating activities (\$ millions)	15.30	<b>11.88</b>
Funds flow from operating activities per diluted share (\$)	0.50	<b>0.39</b>
Cash flows from operating activities (\$ millions)	14.86	<b>10.03</b>
Cash flows from operating activities per diluted share (\$)	0.49	<b>0.33</b>
Cash dividends (\$ millions)	5.42	<b>5.42</b>
Cash dividends declared per common share (\$)	0.18	<b>0.18</b>
Net capital expenditures (\$ millions)	15.48	<b>13.37</b>
Total assets (\$ millions)	462.66	<b>461.70</b>
Long term bank debt (\$ millions)	50.55	<b>56.37</b>
Convertible debentures (\$ millions) <sup>(1)</sup>	57.50	<b>57.50</b>
Net debt	121.72	<b>128.88</b>
Average daily oil and liquids production (bbl)	4,320	<b>4,096</b>
Average daily natural gas production (mmcf)	14.05	<b>14.77</b>
Average daily production (boe)	6,662	<b>6,558</b>
Average oil production weighting (%)	65	<b>62</b>
Average realized commodity field price before the impact of financial risk management contracts (\$/boe)	67.15	<b>68.46</b>
Funds flow netback (\$/boe)	25.52	<b>19.90</b>

(1) Amount is full future face value of the convertible debentures.



	2013			
	Q1	Q2	Q3	Q4
Petroleum and natural gas sales (\$ millions)	37.08	40.59	45.14	35.84
Net earnings/(loss) (\$ millions)	0.23	1.13	(2.35)	(4.91)
Net earnings/(loss) per diluted share (\$)	0.01	0.04	(0.08)	(0.16)
Funds flow from operating activities (\$ millions)	13.90	15.99	16.45	12.15
Funds flow from operating activities per diluted share (\$)	0.46	0.53	0.55	0.40
Cash flows from operating activities (\$ millions)	12.46	14.68	16.30	13.56
Cash flows from operating activities per diluted share (\$)	0.42	0.49	0.54	0.45
Cash dividends (\$ millions) <sup>(1)</sup>	4.75	5.01	5.17	5.42
Cash dividends declared per common share (\$)	0.18	0.18	0.18	0.18
Net capital expenditures (\$ millions)	16.19	2.42	17.54	5.59
Total assets (\$ millions)	450.34	437.88	441.87	452.98
Long term bank debt (\$ millions)	44.02	42.06	43.65	39.97
Convertible debentures (\$ millions) <sup>(2)</sup>	57.50	57.50	57.50	57.50
Net debt	120.10	111.33	117.61	116.24
Average daily oil and liquids production (bbl)	5,113	4,930	4,816	4,625
Average daily natural gas production (mmcf)	15.21	14.77	16.46	15.90
Average daily production (boe)	7,648	7,392	7,560	7,276
Average oil production weighting (%)	67	67	64	64
Average realized commodity field price before the impact of financial risk management contracts (\$/boe)	53.87	60.34	64.90	53.55
Funds flow netback (\$/boe)	20.20	23.77	23.64	18.14

(1) Cash dividends represent the cash portion only and do not include common shares issued through Zargon's Dividend Reinvestment Plan which was suspended September 2013.

(2) Amount is full future face value of the convertible debentures.

	2012			
	Q1	Q2	Q3	Q4
Petroleum and natural gas sales (\$ millions)	44.64	38.52	36.91	37.88
Net earnings/(loss) (\$ millions)	(2.01)	10.54	(4.02)	(9.88)
Net earnings/(loss) per diluted share (\$)	(0.07)	0.34	(0.14)	(0.33)
Funds flow from operating activities (\$ millions)	13.52	12.37	14.35	16.42
Funds flow from operating activities per diluted share (\$)	0.46	0.40	0.48	0.55
Cash flows from operating activities (\$ millions)	11.85	18.00	12.16	16.85
Cash flows from operating activities per diluted share (\$)	0.40	0.57	0.41	0.57
Cash dividends (\$ millions) <sup>(1)</sup>	7.45	7.45	7.75	4.70
Cash dividends declared per common share (\$)	0.30	0.30	0.30	0.18
Net capital expenditures/(dispositions) (\$ millions)	20.95	(26.85)	10.35	25.79
Total assets (\$ millions)	473.69	446.41	440.77	445.11
Long term bank debt (\$ millions)	107.37	24.14	27.58	35.74
Convertible debentures (\$ millions) <sup>(2)</sup>	–	57.50	57.50	57.50
Net debt	124.31	95.20	99.13	113.18
Average daily oil and liquids production (bbl)	5,496	5,384	5,079	5,065
Average daily natural gas production (mmcf)	20.03	17.44	15.33	15.93
Average daily production (boe)	8,834	8,290	7,634	7,720
Average oil production weighting (%)	62	65	67	66
Average realized commodity field price before the impact of financial risk management contracts (\$/boe)	55.53	51.06	52.55	53.33
Funds flow netback (\$/boe)	16.82	16.39	20.43	23.12

(1) Cash dividends represent the cash portion only and do not include common shares issued through Zargon's Dividend Reinvestment Plan.

(2) Amount is full future face value of the convertible debentures.

Additional information regarding the Company and its business operations, including the Company's Annual Information Form for December 31, 2013, is available on the Company's SEDAR profile at [www.sedar.com](http://www.sedar.com).

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

Calgary, Alberta  
August 11, 2014

## CONSOLIDATED BALANCE SHEETS

(unaudited)

(\$ thousands)	Notes	June 30, 2014	December 31, 2013
<b>ASSETS</b>			
Trade and other receivables		14,960	14,087
Deposits and prepaid expenses		1,683	997
Investment in marketable securities		800	800
Derivatives	11,12	232	22
<b>Total current assets</b>		<b>17,675</b>	<b>15,906</b>
Long term deposits		126	128
Property, plant and equipment, net	4	414,084	408,719
Intangible exploration and evaluation assets	5	12,249	13,331
Goodwill	4,5	4,770	2,969
Deferred tax assets		12,792	11,924
<b>Total assets</b>		<b>461,696</b>	<b>452,977</b>
<b>LIABILITIES</b>			
Trade and other payables		30,249	32,450
Cash dividends payable	6	1,808	1,805
Provisions	7	396	399
Derivatives	11,12	10,268	5,000
<b>Total current liabilities</b>		<b>42,721</b>	<b>39,654</b>
Long term bank debt	8	56,368	39,968
Convertible debentures		53,084	52,478
Derivatives	11,12	119	210
Provisions	7	135,307	135,177
Deferred tax liabilities		12,346	11,945
<b>Total liabilities</b>		<b>299,945</b>	<b>279,432</b>
Commitments and contingencies	7,8,10,11,12		
<b>EQUITY</b>			
Shareholders' capital	9	256,591	256,092
Accumulated other comprehensive income		544	493
Contributed surplus	10	12,770	12,423
Equity component of debentures		3,640	3,640
Deficit		(111,794)	(99,103)
<b>Total equity</b>		<b>161,751</b>	<b>173,545</b>
<b>Total equity and liabilities</b>		<b>461,696</b>	<b>452,977</b>

See accompanying notes to the interim consolidated financial statements.

## CONSOLIDATED STATEMENTS OF EARNINGS/(LOSS) AND COMPREHENSIVE EARNINGS/(LOSS)

(unaudited)		Three Months Ended June 30,		Six Months Ended June 30,	
(\$ thousands, except per share amounts)	Notes	2014	2013	2014	2013
Petroleum and natural gas sales		40,860	40,591	81,122	77,669
Royalties		(8,193)	(7,068)	(14,915)	(13,738)
<b>PETROLEUM AND NATURAL GAS REVENUE, NET OF ROYALTIES</b>		<b>32,667</b>	<b>33,523</b>	<b>66,207</b>	<b>63,931</b>
Gain/(loss) on unrealized derivatives	11,12	(1,774)	2,084	(4,967)	(2,689)
Gain/(loss) on realized derivatives	11,12	(3,734)	961	(6,032)	2,238
<b>GAIN/(LOSS) ON DERIVATIVES</b>		<b>(5,508)</b>	<b>3,045</b>	<b>(10,999)</b>	<b>(451)</b>
<b>TOTAL INCOME</b>		<b>27,159</b>	<b>36,568</b>	<b>55,208</b>	<b>63,480</b>
Operating		11,382	12,173	21,601	24,060
Transportation		377	448	887	899
General and administrative		3,029	3,035	5,997	5,947
Transaction costs		146	97	193	97
Exploration and evaluation	5	657	1,464	758	2,323
(Gain)/loss on disposal of properties	4	(1,257)	4,411	(1,927)	931
Share-based compensation	10	546	502	846	715
Unrealized foreign exchange gain		(14)	(90)	(26)	(188)
Depletion and depreciation		11,904	11,089	23,308	22,494
<b>EXPENSES</b>		<b>26,770</b>	<b>33,129</b>	<b>51,637</b>	<b>57,278</b>
<b>EARNINGS BEFORE FINANCE EXPENSES AND INCOME TAXES</b>		<b>389</b>	<b>3,439</b>	<b>3,571</b>	<b>6,202</b>
Interest and financing charges	8	675	628	1,282	1,190
Interest on convertible debentures		862	870	1,725	1,725
Accretion on convertible debentures		303	315	606	630
Accretion of asset retirement obligations	7	1,067	715	2,165	1,437
<b>FINANCE EXPENSES</b>		<b>2,907</b>	<b>2,528</b>	<b>5,778</b>	<b>4,982</b>
<b>EARNINGS/(LOSS) BEFORE INCOME TAXES</b>		<b>(2,518)</b>	<b>911</b>	<b>(2,207)</b>	<b>1,220</b>
Current tax expense		72	172	145	344
Deferred tax recovery		(570)	(388)	(503)	(476)
<b>INCOME TAXES RECOVERY</b>		<b>(498)</b>	<b>(216)</b>	<b>(358)</b>	<b>(132)</b>
<b>NET EARNINGS/(LOSS) FOR THE PERIOD</b>		<b>(2,020)</b>	<b>1,127</b>	<b>(1,849)</b>	<b>1,352</b>
Currency translation adjustment that may be reclassified subsequently to net earnings		(912)	756	51	1,185
<b>OTHER COMPREHENSIVE EARNINGS/(LOSS) FOR THE PERIOD</b>		<b>(912)</b>	<b>756</b>	<b>51</b>	<b>1,185</b>
<b>TOTAL COMPREHENSIVE EARNINGS/(LOSS) FOR THE PERIOD</b>		<b>(2,932)</b>	<b>1,883</b>	<b>(1,798)</b>	<b>2,537</b>
<b>NET EARNINGS/(LOSS) PER SHARE</b>					
Basic		(0.07)	0.04	(0.06)	0.05
Diluted		(0.07)	0.04	(0.06)	0.04

See accompanying notes to the interim consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(unaudited)

(\$ thousands)	Notes	Shareholders' Capital	Currency Translation Adjustment	Contributed Surplus	Equity Component of Convertible Debentures	Deficit	Total Equity
<b>Balance at December 31, 2013</b>		<b>256,092</b>	<b>493</b>	<b>12,423</b>	<b>3,640</b>	<b>(99,103)</b>	<b>173,545</b>
Net loss for the period		-	-	-	-	(1,849)	(1,849)
Dividends declared	6	-	-	-	-	(10,842)	(10,842)
Share-based compensation	10	-	-	846	-	-	846
Exercise of share options	9	499	-	(499)	-	-	-
Translation differences on foreign subsidiary		-	51	-	-	-	51
<b>Balance at June 30, 2014</b>		<b>256,591</b>	<b>544</b>	<b>12,770</b>	<b>3,640</b>	<b>(111,794)</b>	<b>161,751</b>
<b>Balance at December 31, 2012</b>		254,400	(998)	11,133	3,640	(71,592)	196,583
Net earnings for the period		-	-	-	-	1,352	1,352
Dividends declared	6	-	-	-	-	(10,783)	(10,783)
Issue of common shares pursuant to the DRIP	6	1,022	-	-	-	-	1,022
Share-based compensation	10	-	-	715	-	-	715
Exercise of share options		294	-	(294)	-	-	-
Translation differences on foreign subsidiary		-	1,185	-	-	-	1,185
<b>Balance at June 30, 2013</b>		<b>255,716</b>	<b>187</b>	<b>11,554</b>	<b>3,640</b>	<b>(81,023)</b>	<b>190,074</b>

See accompanying notes to the interim consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited) (\$ thousands)	Notes	Three Months Ended June 30,		Six Months Ended June 30,	
		2014	2013	2014	2013
<b>OPERATING ACTIVITIES</b>					
Net earnings/(loss) for the period		(2,020)	1,127	(1,849)	1,352
Adjustments for non-cash items:					
(Gain)/loss on sale of properties	4	(1,257)	4,411	(1,927)	931
(Gain)/loss on unrealized derivatives	11,12	1,774	(2,084)	4,967	2,689
Depletion and depreciation	4	11,904	11,089	23,308	22,494
Accretion of asset retirement obligations	7	1,067	715	2,165	1,437
Accretion of convertible debentures		303	315	606	630
Share-based compensation	10	546	502	846	715
Unrealized foreign exchange gain		(14)	(90)	(26)	(188)
Deferred tax recovery		(570)	(388)	(503)	(476)
Exploration and evaluation expenses	5	657	1,464	758	2,323
Asset retirement expenditures		(515)	(1,074)	(1,170)	(2,017)
Funds flow from operating activities		11,875	15,987	27,175	29,890
Changes in operating working capital		(1,849)	(1,310)	(2,289)	(2,753)
Net cash from operating activities		10,026	14,677	24,886	27,137
<b>INVESTING ACTIVITIES</b>					
Additions to property, plant and equipment	4	(16,495)	(13,890)	(33,418)	(33,250)
Additions to intangible exploration and evaluation assets	5	(147)	(157)	(235)	(263)
Proceeds on disposal of property, plant and equipment	4	5,872	11,599	7,402	14,868
Proceeds on disposal of intangible exploration and evaluation assets	5	515	33	515	33
Acquisition of property, plant and equipment	4,5	(3,111)	–	(3,111)	–
Change in long term deposits		2	–	2	–
Changes in investing working capital		2,938	(5,295)	(1,602)	(5,120)
Net cash used in investing activities		(10,426)	(7,710)	(30,447)	(23,732)
<b>FINANCING ACTIVITIES</b>					
Advances of bank debt		5,822	(1,958)	16,400	6,325
Cash dividends paid to shareholders	6	(5,424)	(5,007)	(10,842)	(9,761)
Changes in financing working capital		2	(2)	3	31
Net cash (used)/provided by financing activities		400	(6,967)	5,561	(3,405)
<b>NET CHANGE IN CASH DURING THE PERIOD AND CASH, END OF PERIOD</b>		–	–	–	–

See accompanying notes to the interim consolidated financial statements.

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

*For the three and six months ended June 30, 2014, with comparative figures for 2013 (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, 333-5<sup>th</sup> Avenue SW, Calgary, Alberta. The interim consolidated financial statements of the Company as at and for the period ended June 30, 2014 and for its 2013 comparative period 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.

## **2. BASIS OF PRESENTATION**

### **(a) Statement of compliance:**

The unaudited interim consolidated financial statements for the three and six month periods ended June 30, 2014 have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") applicable to the preparation of interim financial statements, including International Accounting Standards ("IAS") 34, Interim Financial Reporting. The same accounting policies and methods of computation were followed in the preparation of these unaudited interim consolidated financial statements as were followed in the preparation of the audited annual consolidated financial statements for the fiscal year ended December 31, 2013. New and amended accounting standards have been evaluated and disclosed in Note 3. The disclosures provided below are incremental to those included with the audited annual consolidated financial statements. These unaudited interim consolidated financial statements for the three and six month periods ended June 30, 2014 should be read in conjunction with the annual consolidated financial statements for the year ended December 31, 2013. These consolidated financial statements were approved and authorized for issue by the Board of Directors on August 11, 2014.

### **(b) Basis of measurement:**

The interim consolidated financial statements have been prepared on the historical cost basis except for the derivative financial instruments and the investment in marketable securities which are 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. ACCOUNTING POLICIES

#### (a) New and amended standards adopted by the Company:

The following new or amended standards were adopted by the Company for the interim period:

- IAS 36 "Impairment of Assets" has been amended to require additional disclosures in the event of recognizing an impairment of assets. The retrospective application of this standard is required to be adopted for periods on or after January 1, 2014. The amendment did not have a significant impact on the Company's consolidated financial statements.
- IFRIC 21 "Levies" clarifies that an entity recognizes a liability for a levy when the activity that triggers payment, as identified by the relevant legislation, occurs. The interpretation also clarifies that no liability should be recognized before the specified minimum threshold to trigger that levy is reached. IFRIC 21 is required to be adopted retrospectively for fiscal years beginning January 1, 2014, with earlier adoption permitted. The adoption of this IFRIC did not have an impact on the Company's consolidated financial statements.

#### (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" replaces the current multiple classification and measurement models for financial assets and liabilities with a single model. IFRS 9 also details the new general hedge accounting model. Hedge accounting remains optional and the new model is intended to allow reporters to better reflect risk management activities in the financial statements and provide more opportunities to apply hedge accounting. The Company does not employ hedge accounting for its risk management contracts currently in place. IFRS 9 will be effective for annual periods beginning on or after January 1, 2018, with early adoption permitted. The Company has not yet determined the impact on the Company's consolidated financial statements.
- IFRS 15 "Revenue from Contracts with Customers" specifies how and when to recognize revenue as well as requiring entities to provide users of financial statements with more informative, relevant disclosures. The standard supersedes IAS 18 "Revenue", IAS 11 "Construction Contracts" and a number of revenue-related interpretations. IFRS 15 will be effective for annual periods beginning on or after January 1, 2017 with early adoption permitted. The Company has not yet determined the impact on the Company's consolidated financial statements.

### 4. PROPERTY, PLANT AND EQUIPMENT

	Six Months Ended
(\$ thousands)	June 30, 2014
Cost, December 31, 2013	580,267
Accumulated depletion and depreciation	(171,548)
Net carrying amount, December 31, 2013	408,719
Additions	35,345
Disposals	(7,316)
Acquisition of property, plant and equipment	2,348
Change in asset retirement obligation	(1,958)
Assets transferred from intangible exploration and evaluation assets	79
Exchange differences	175
Depletion and depreciation	(23,308)
Net carrying amount, June 30, 2014	414,084
Cost, June 30, 2014	603,331
Accumulated depletion and depreciation	(189,247)
Net carrying amount, June 30, 2014	414,084



During the three and six months ended June 30, 2014, the Company disposed of certain assets for gross cash proceeds of \$5.87 million (2013 - \$11.60 million) and \$7.40 million (2013 - \$14.87 million), respectively. The dispositions for the three and six months resulted in gains of \$1.26 million (2013 - \$4.41 million loss) and \$1.93 million (2013 - \$0.93 million loss), respectively.

In June 2014, the Company closed a property acquisition in the Alberta Plains South area. The property acquisition was accounted for as a business combination under IFRS 3. Consideration paid consisted of \$3.11 million of cash in exchange for property, plant and equipment, exploration and evaluation assets, goodwill and decommissioning obligations.

#### 5. INTANGIBLE EXPLORATION AND EVALUATION ASSETS AND GOODWILL

(\$ thousands)	Goodwill	E&E Assets	Total
Cost:			
Balance at December 31, 2013	2,969	13,331	16,300
Additions	–	235	235
Disposals	–	(515)	(515)
Acquisition	1,801	30	1,831
Transfers to property, plant and equipment	–	(79)	(79)
Exploration and evaluation expense	–	(758)	(758)
Exchange differences	–	5	5
Balance at June 30, 2014	4,770	12,249	17,019

#### 6. CASH DIVIDENDS

During the period, the Company declared dividends to the shareholders in the aggregate amount of \$10.84 million (2013 – \$10.78 million) in accordance with the following schedule:

2014 Dividends	Record Date	Dividend Date	Per Common Share
January	January 31, 2014	February 18, 2014	\$0.06
February	February 28, 2014	March 17, 2014	\$0.06
March	March 31, 2014	April 15, 2014	\$0.06
April	April 30, 2014	May 15, 2014	\$0.06
May	May 31, 2014	June 16, 2014	\$0.06
June	June 30, 2014	July 15, 2014	\$0.06

(1) The 2013 cash dividends include a non-cash equity issuance amount of \$1.02 million for the Dividend Reinvestment Plan which was suspended September 2013.

Subsequent to the end of the period and prior to the consolidated financial statements being authorized for issue on August 11, 2014, the Company declared dividends of \$1.81 million or \$0.06 per share for July 2014.

## 7. PROVISIONS

(\$ thousands)	Asset Retirement Obligations	Other	Total
Balance at December 31, 2013	135,177	399	135,576
Provisions made during the period	554	–	554
Foreign exchange and other	25	–	25
Provisions used during the period	(1,170)	(3)	(1,173)
Provisions related to dispositions	(4,535)	–	(4,535)
Provision related to acquisition	1,068	–	1,068
Revision to estimated provisions	2,023	–	2,023
Accretion	2,165	–	2,165
Balance at June 30, 2014	135,307	396	135,703
Current	–	396	396
Non-current	135,307	–	135,307

### Asset retirement obligation:

The asset retirement obligations were calculated using a discount factor of 3.25 percent (December 31, 2013 – 3.25 percent) being the risk-free rate related to the liability and based on the Government of Canada long term bond rate. These obligations are expected to be incurred over the next 55 years. An inflation rate of two percent per annum (December 31, 2013 – two percent) used in the calculation of the present value of the asset retirement obligation remains unchanged.

### Other:

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. The interest expense related to the Part XII.6 tax has been paid to the Canada Revenue Agency and the remaining provision is currently \$0.40 million.

## 8. LONG TERM BANK DEBT

On June 13, 2014, Zargon amended and renewed its syndicated committed credit facilities, the result of which was the reduction of the available facilities and borrowing base to \$150 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 364 day period with the provision for an annual extension at the option of the lenders and upon notice from Zargon's Management. The next renewal date is June 24, 2015, with a semi-annual review taking place in the fall of 2014. Should the facilities not be renewed, they convert to one year non-revolving term facilities at the end of the revolving 364 day period. Repayment would not be required until the end of the non-revolving term, and, as such, these facilities have been classified as long term debt.

Interest rates fluctuate under the syndicated facilities with Canadian prime, US prime and US base rates plus an applicable margin between 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, 2014, \$56.37 million (December 31, 2013 - \$39.97 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, 2014, the approximate value of outstanding letters of credit totalled \$0.87 million (December 31, 2013 - \$0.87 million). The letters of credit reduce the amount of Zargon's available credit facilities to \$92.76 million at June 30, 2014 (December 31, 2013 - \$124.16 million).

Zargon reviews its compliance with its bank debt covenants on a quarterly basis and is in compliance as at June 30, 2014.

## 9. SHARE CAPITAL

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

Common Shares (thousands)	Six Months Ended June 30, 2014	
	Number of Shares	Amount (\$)
Balance, as at December 31, 2013	30,087	256,092
Share awards exercised	46	–
Share-based compensation recognized on exercise of share options	–	499
Balance, as at June 30, 2014	30,133	256,591

## 10. SHARE-BASED PAYMENTS

### Share Award Plan

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. Zargon uses a fair value methodology to value the share awards.

Due to the nature of the plan, Zargon is required to estimate the forfeiture rate upon initial calculation of fair values. The forfeiture rate is estimated at 10 percent while the interest rate and volatility is set at a historical rate as there is no exercise price. The fair value of the share award is determined on the grant date at the prior day closing price of the Company’s common shares on the Toronto Stock Exchange.

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

	Six Months Ended June 30, 2014
	Number of Share Awards (thousands)
Outstanding, as at December 31, 2013	563
Share awards granted	296
Share awards exercised	(46)
Share awards forfeited	(8)
Outstanding, as at June 30, 2014	805

### Common Share 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”) expired in the first quarter of 2013. 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 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 New Plan:

	Six Months Ended June 30, 2014	
	Number of Share Options (thousands)	Weighted Average Exercise Price Initial and Modified (\$/share)
Outstanding at beginning of period	391	18.06 / 14.39
Share options expired	(173)	15.89
Share options forfeited	(11)	19.81
Outstanding at end of period	207	19.77 / 16.84

### Share-based Compensation

The share awards for the three and six months ended June 30, 2014, resulted in share-based compensation of \$0.55 million (2013 - \$0.50 million) and \$0.85 million (2013 - \$0.72 million), respectively.

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.

### Weighted Average Number of Total Shares

(thousands of shares)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Weighted average number of common shares – basic	30,128	29,995	30,114	29,952
Weighted average number of common shares – diluted	30,128	30,210	30,114	30,108

Dilution amounts for the three and six months ended June 30, 2014 of nil shares (2013 - 0.22 million shares) and nil shares (2013 – 0.16 million shares) were added to the weighted average number of shares outstanding during the period in the calculation of diluted per share amounts. These share additions represent the dilutive effect of share rights according to the treasury stock method.

The convertible debenture could potentially dilute basic earnings per share, but was not included in the calculation of diluted earnings per share because it is antidilutive for the three and six months ended June 30, 2014.

## 11. FINANCIAL INSTRUMENTS

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates cannot be determined with precision as they are subjective in nature and involve uncertainties and matters of judgement.

The following table shows the comparison of the carrying and fair value of the company's financial instruments:

(thousands)	June 30, 2014		December 31, 2013	
	Carrying Amount (\$)	Fair Value (\$)	Carrying Value (\$)	Fair Value (\$)
<b>Loans and receivables:</b>				
Trade and other receivables	14,960	14,960	14,087	14,087
<b>Fair value through profit and loss:</b>				
Derivative assets	232	232	22	22
Derivative liabilities	10,387	10,387	5,210	5,210
<b>Fair value through other comprehensive income:</b>				
Investment in marketable securities	800	800	800	800
<b>Other liabilities:</b>				
Trade and other payables	30,249	30,249	32,450	32,450
Cash dividends	1,808	1,808	1,805	1,805
Long term bank debt	56,368	56,368	39,968	39,968
Convertible debentures	53,084	58,075	52,478	56,638

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

The investment in marketable securities is classified as "available-for-sale" and is carried at fair value. This investment is available on the active market and the Company classifies the fair value of this investment according to the following hierarchy based on the amount of observable inputs used to value the instrument.

- Level I

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

- Level II

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

- Level III

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

The Company's risk management contracts have been assessed on the fair value hierarchy described above and are classified as Level II. Assessment of the significance of a particular input into the fair value measurement requires judgment and may affect the placement within the fair value hierarchy level. The Company's policy is to recognize transfers into and out of fair value hierarchy levels as of the date of the event or change in circumstances that caused the transfer. The company does not have any fair value measurements classified as Level III.

At each reporting date, the Company determines whether transfers have occurred between levels in the hierarchy by reassessing the level of classification for each financial asset and financial liability measured or disclosed at fair value in the financial statements. Assessment of the significance of a particular input to the fair value measurement requires judgement and may affect the placement within the fair value hierarchy. During the period ended June 30, 2014, there were no transfers between levels I, II or III.

The carrying value of receivables and other liabilities approximate their fair value due to their short maturities, except for the convertible debentures which are determined using Level I inputs.

### **Financial Risk Management**

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

- **Market Risk**

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

- **Commodity Price Risk**

Commodity price risk is the risk that the fair value of future cash flows will fluctuate as a result in changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian and United States dollar, but also world economic events that dictate the levels of supply and demand. As a means of mitigating exposure to commodity price risk volatility, the Company has entered into various derivative agreements. The use of derivative instruments is governed under formal policies and is subject to limits established by the Board of Directors. The Company's policy is to not use derivative financial instruments for speculative purposes.

Natural Gas – To partially mitigate the natural gas commodity price risk, the Company has entered into swaps, which fix the Canadian dollar AECO prices and natural gas basis hedges.

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

- **Interest Rate Risk**

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. Borrowings under bank credit facilities are market rate based (variable interest rates); thus, carrying values approximate fair values.

At the June 30, 2014 debt pricing levels, the increase or decrease in net earnings for the year for each one percent change in interest rates would amount to \$0.26 million (June 30, 2013 - \$0.22 million) before swaps.

- **Foreign Exchange Risk**

Foreign currency exchange rate risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in foreign exchange rates. The underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. As Zargon operates in North America, fluctuations in the exchange rate between the US/Canadian dollar can have a significant effect on the Company's reported results. A \$0.01 change in the US to Canadian dollar exchange rate would have resulted in a \$0.39 million (June 30, 2013 - \$0.39 million) increase or decrease in net earnings for the period ended June 30, 2014. In order to mitigate the Company's exposure to foreign exchange fluctuations, the Company may enter into foreign exchange derivative agreements.

- **Credit Risk**

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

The maximum credit risk exposure associated with accounts receivable and derivative assets is the total carrying value. The Company monitors these balances monthly to limit the risk associated with collection. Of Zargon's accounts receivable at June 30, 2014, approximately 52 percent (December 31, 2013 - 58 percent) was owing from two companies and Zargon anticipates full collection.

The Company's allowance for doubtful accounts at June 30, 2014 was \$0.21 million (December 31, 2013 - \$0.26 million). During 2014, the Company did not record any additional provision for non-collectible accounts receivable.

When determining whether amounts that are past due are collectible, management assesses the credit worthiness and past payment history of the counterparty, as well as the nature of the past due amount. Zargon considers all material amounts greater than 90 days to be past due. As at June 30, 2014, \$0.53 million of accounts receivable are past due, excluding amounts described above, all of which are considered to be collectable.

- Liquidity Risk

Liquidity risk is the risk the Company will encounter difficulties in meeting its financial liability obligations. The Company manages its liquidity risk through funds flow and debt management.

As at June 30, 2014, Zargon had available unused committed bank credit facilities of approximately \$92.76 million compared to \$124.16 million at December 31, 2013. The Company believes it has sufficient funding through the use of these facilities to meet foreseeable borrowing requirements.

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

(\$ thousands)	1 year	2-4 years	Total
Trade and other payables	30,249	–	30,249
Cash dividends payable	1,808	–	1,808
Derivative liabilities	10,268	119	10,387
Long term bank debt	–	56,368	56,368
Interest on convertible debentures	3,450	6,900	10,350
Convertible debentures <sup>(1)</sup>	–	57,500	57,500

(1) Amount is the full face value of the convertible debenture at \$57.50 million.

#### Commodity Price Sensitivities

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

Fluctuations of 10 percent in commodity prices could have resulted in unrealized gains or losses of \$8.83 million (June 30, 2013 – \$6.59 million) and \$0.87 million (June 30, 2013 – nil) for oil and gas risk management contracts impacting net earnings for the six months ended June 30, 2014, respectively.

#### 12. DERIVATIVE CONTRACTS

The Company is a party to certain financial instruments that have fixed the price of a portion of its oil production and interest rates. The Company enters into these contracts for risk management purposes only in order to protect a portion of its future cash flows from the volatility of oil and natural gas commodity prices and interest rates. For financial risk management contracts, any unrealized gains or losses are recorded in earnings based on the fair value (mark-to-market) of the contracts at each reporting period. The unrealized loss on the statement of earnings/(loss) and comprehensive earnings/(loss) for the three and six month periods of 2014 was \$1.77 million (2013 - \$2.08 million gain) and \$4.97 million (2013 - \$2.69 million loss), respectively. The realized loss on the statement of earnings/(loss) and comprehensive earnings/(loss) for the three and six month periods of 2014 was \$3.73 million (2013 - \$0.96 million gain) and \$6.03 million (2013 - \$2.24 million gain), respectively.

As at June 30, 2014, the Company had the following outstanding commodity and interest risk management contracts:

**Commodity Financial Risk Management Contracts:**

	Rate	Weighted Average Price	Range of Terms	Fair Market Value Asset/(Liability) (\$ thousands)
Oil swaps	1,800 bbl/d	\$90.24 US/bbl	Jul. 1/14 – Dec. 31/14	(4,895)
	400 bbl/d	\$91.73 US/bbl	Jul. 1/14 – Mar. 31/15	(1,313)
	400 bbl/d	\$93.20 US/bbl	Jul. 1/14 – Jun. 30/15	(1,343)
	800 bbl/d	\$94.41 US/bbl	Jan. 1/15 – Jun. 30/15	(789)
	400 bbl/d	\$99.60 Cdn/bbl	Jul. 1/14 – Dec. 31/14	(848)
Natural gas swaps	9,000 gj/d	\$3.69 Cdn/gj	Jul. 1/14 – Oct. 31/14	(651)
	6,000 gj/d	\$4.25 Cdn/gj	Nov. 1/14 – Mar. 31/15	(105)
<b>Total Fair Market Value, Commodity Price Financial Contracts</b>				<b>(9,944)</b>

Oil swaps are settled against the NYMEX WTI pricing index.

**AECO Basis Gas Rate Risk Management Contract:**

	Rate	Average Price	Range of Terms	Fair Market Value Asset/(Liability) (\$ thousands)
AECO to NYMEX basis	6,000 MMBtu/d	\$(0.4850) US/MMBtu	Jul. 1/14 – Oct. 31/14	(217)
NYMEX to AECO basis	3,000 MMBtu/d	\$(0.5000) US/MMBtu	Jul. 1/14 – Oct. 31/14	114
NYMEX to AECO basis	3,000 MMBtu/d	\$(0.5075) US/MMBtu	Jul. 1/14 – Oct. 31/14	117
<b>Total Fair Market Value, Interest Rate Financial Contracts</b>				<b>14</b>

AECO basis natural gas swaps are settled against the AECO pricing index.

**Interest Rate Risk Management Contracts:**

	Notional Value	Weighted Average Interest Rate <sup>(1)</sup>	Range of Terms	Fair Market Value Asset/(Liability) (\$ thousands)
Interest rate swaps	\$20,000,000/month	1.640%	Jul. 1/14 – Jul. 26/16	(87)
	\$20,000,000/month	1.731%	Jul. 1/14 – Aug. 26/16	(138)
<b>Total Fair Market Value, Interest Rate Financial Contracts</b>				<b>(225)</b>

<sup>(1)</sup> Excludes the current stamping fee of 2.0 percent for each swap.

Interest rate swaps are reset monthly and settled against the BA-CDOR interest rate index.

**13. SUBSEQUENT EVENT**

In July 2014, Zargon closed two transactions to sell working interests in various Alberta Plains North properties for a total consideration of \$0.90 million.



**BOARD OF DIRECTORS**

Craig H. Hansen

*Calgary, Alberta*

K. James Harrison <sup>(2)</sup>

Chairman of the Board

*Oakville, Ontario*

Kyle D. Kitagawa <sup>(1)</sup>

*Calgary, Alberta*

Geoffrey C. Merritt <sup>(1)</sup>

*Calgary, Alberta*

Jim Peplinski <sup>(1) (2)</sup>

*Calgary, Alberta*

Grant A. Zawalsky <sup>(2)</sup>

*Calgary, Alberta*

**OFFICERS**

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President and Chief Executive Officer and Interim Chief Financial Officer

Leslie E. Burden

Vice President, Land

Randolph J. Doetzel

Vice President, Operations

Christopher M. Hustad

Vice President, Alberta Plains South

Pete H.S. Janjua

Vice President, Williston Basin

Brian G. Kergan

Vice President, Corporate Development

Kevin C.Y. Lee

Vice President, Alberta Plains North

Robert T. Moriyama

Vice President, Enhanced Recovery

*(1) Audit and Reserves Committee*

*(2) Governance and Compensation Committee*

**STOCK EXCHANGE LISTING****Toronto Stock Exchange**

Zargon Oil & Gas Ltd.

Common Shares

Trading Symbol: ZAR

Zargon Oil & Gas Ltd.

Convertible Debentures

Trading Symbol: ZAR.DB

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