2016 Q1 FINANCIAL REPORT

FINANCIAL AND OPERATING HIGHLIGHTS

	Three Months Ended March 31,		
(unaudited)	**2016**	2015	Percent Change
Financial			
Income and Investments ($ millions)			
Gross petroleum and natural gas sales	**9.61**	16.41	(41)
Funds flow from/(used in) operating activities	**(0.28)**	7.24	(104)
Cash flows from operating activities	**2.07**	6.67	(69)
Cash dividends	**–**	2.72	(100)
Net loss	**(8.82)**	(4.88)	(81)
Net capital expenditures	**2.47**	5.40	(54)
Per Share, Basic			
Funds flow from/(used in) operating activities ($/share)	**(0.01)**	0.24	(104)
Cash flows from operating activities ($/share)	**0.07**	0.22	(68)
Net loss ($/share)	**(0.29)**	(0.16)	(81)
Cash Dividends ($/common share)	**–**	0.09	(100)
Balance Sheet at Period End ($ millions)			
Property, plant and equipment	**225.28**	337.45	(33)
Exploration and evaluation assets	**5.66**	6.75	(16)
Long term bank debt	**64.59**	49.91	29
Convertible debentures at maturity	**57.50**	57.50	–
Shareholders' equity	**43.28**	155.67	(72)
Total Common Shares Outstanding at Period End (millions)	**30.47**	30.27	1
Operating			
Average Daily Production			
Oil and liquids (bbl/d)	**3,503**	3,928	(11)
Natural gas (mmcf/d)	**4.04**	5.24	(23)
Equivalent (boe/d)	**4,176**	4,802	(13)
Average Selling Price (before the impact of financial risk management contracts)			
Oil and liquids ($/bbl)	**28.27**	42.26	(33)
Natural gas ($/mcf)	**1.64**	3.12	(47)
Wells Drilled, Net	**–**	–	–
Undeveloped Land at Period End (thousand net acres)	**71**	85	(16)

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 were suspended after the October 2015 dividend paid on November 16, 2015.

Production
(boe/d)

Message to Shareholders [1]

Zargon Oil & Gas Ltd. has released financial and operating results for the first quarter of 2016. Specific financial and operating highlights in the first quarter of 2016 include:

- Funds flow from operating activities of a negative $0.3 million compare to the positive $3.6 million recorded in the prior quarter, and the positive $7.2 million reported in first quarter of 2015. The reduction in funds flow is primarily due to Zargon's sharply lower first quarter 2016 field oil price of $28.27 per barrel, down 30 percent from the fourth quarter 2015 field oil price of $40.19 per barrel and down 33 percent from the first quarter 2015 field oil price of $42.26 per barrel.
- Reflecting continued restricted conventional capital programs, first quarter 2016 production averaged 3,503 barrels of oil and liquids per day, a four percent decrease from the preceding quarter, and first quarter 2016 natural gas production averaged 4.0 million cubic feet per day, a four percent decrease from the preceding quarter. Total production averaged 4,176 barrels of oil equivalent per day, a four percent decrease from the preceding quarter. During the quarter, oil and liquids production represented 84 percent of total production based on a 6:1 equivalent basis.
- First quarter 2016 exploration and development capital expenditures (excluding property acquisitions and dispositions) were $2.4 million and included $2.0 million of expenditures related to the Little Bow ASP project ($0.2 million exploitation and $1.8 million chemical costs). No wells were drilled in the quarter.

Oil and Liquids Production
(bbl/d)

Ongoing Cost Reduction Initiatives [1]

In response to the sustained low oil price environment, Zargon has continued to focus on reducing operating and transportation costs and general and administrative costs. In the 2016 first quarter, operating and transportation costs totaled $7.12 million ($18.75 per barrel of oil equivalent), down 25 percent from the 2015 first quarter cost of $9.52 million ($22.02 per barrel of oil equivalent) and down 19 percent from the 2015 fourth quarter cost of $8.74 million ($21.88 per barrel of oil equivalent).

In aggregate, operating and transportation costs have been reduced from $42.9 million in 2014, to $36.0 million in 2015 and to a budgeted $30.0 million in 2016. These reductions have been accomplished through lower margin property sales (completed in 2014), comprehensive cost reviews, field supplier and consultant reductions and field office consolidations. In particular, the projected 2016 cost savings reflect lower electricity costs, lower field contractor costs and reduced Little Bow ASP facility and field pumping costs due to the polymer only streamlined facility operations and improved pumping designs. Zargon will continue to focus on cost containment initiatives, and further reductions in operating costs are anticipated to be delivered throughout the year.

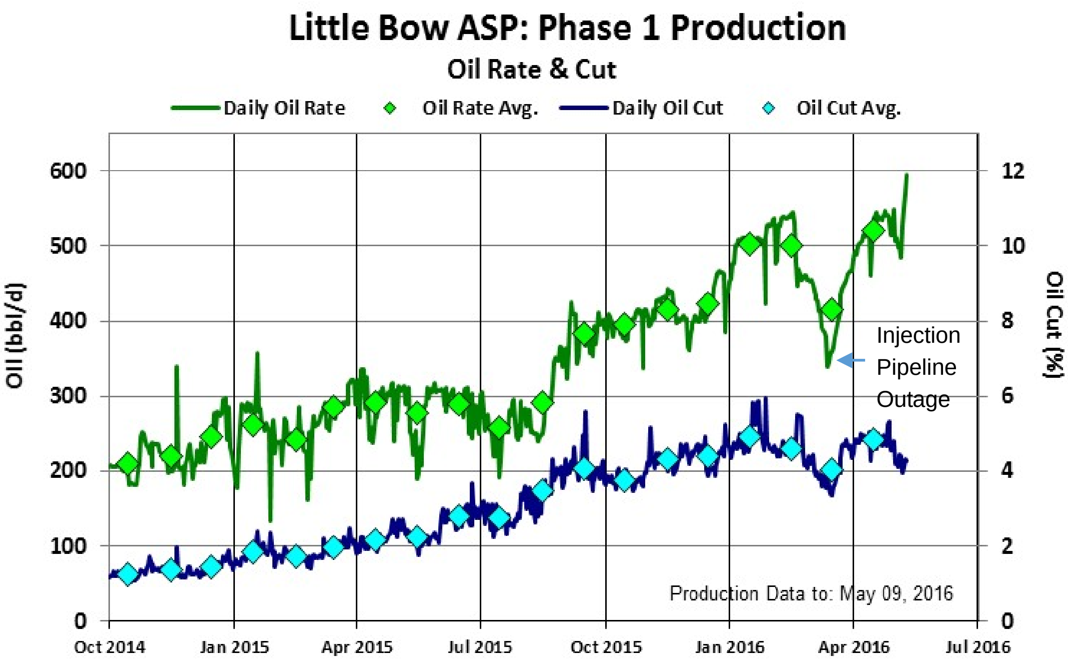
Similarly, general and administrative costs and transactions costs (inclusive of one-time adjustments) have been reduced from $13.4 million in 2014, to $8.4 million in 2015 and a forecasted $6.5 million in 2016, based on the 2016 first quarter reported cost of $1.73 million. These reductions have been accomplished through office staff and consultant reductions (43 percent), comprehensive cost reviews, salary roll backs, consultant rate reductions and office space adjustments.

Natural Gas Production
(mmcf/d)

Little Bow Alkaline Surfactant Polymer ("ASP") Project Update [1]

In March 2014, Zargon commenced chemical injection of large volumes of dilute chemical solution into the partially depleted Little Bow Mannville I pool to recover incremental oil reserves. To date, 7.0 million barrels of ASP solution has been injected into the first phase of the project. This injection volume is equal to about 22 percent of the targeted reservoir pore volume which compares to the planned 30 percent ASP phase 1 injection. This March, in an effort to conserve funds, we have suspended the alkali and surfactant injections into the pool, while maintaining the polymer injections. The alkali and surfactant injections can be reinitiated once oil prices improve. Our model studies indicate that a one year suspension of the alkali and surfactant injections will not impact the ultimate oil recovery of the flood.

For the last three years, Zargon has redirected available capital to the Little Bow ASP tertiary recovery project. Although 2014-2015 Little Bow ASP production results showed clear evidence of the formation of the desired oil banks, oil production volumes had not met expectations. In 2015, Zargon responded with a $6.8 million remediation and optimization program that included the drilling of six infill locations. Production results (provided graphically below) from the program are encouraging and show improved recent ASP project rates of 580 barrels of oil per day. In particular, the production in the north and central regions of the flood has exceeded 500 barrels of oil per day, a level that demonstrates strong oil bank formation and suggests that the full 12 percent forecast tertiary oil recoveries will be reached in these areas.



In addition to the $2.0 million of ASP exploitation and chemical capital expenditures, Zargon spent $0.4 million on conventional oil exploitation capital programs in the first quarter of 2016. These conventional capital programs focused on minor waterflood and facility modifications that continue to enable Zargon to have an industry low base oil production decline (excluding ASP) of 12 percent per year. Zargon has not drilled any conventional oil exploitation wells in 2015 or 2016.

Zargon's non-ASP conventional properties tend to be pressure supported by waterflood injections or natural reservoir aquifers and consequently provide long-life low-decline oil volumes. Approximately half of these production volumes are produced from Mississippian (Midale, Frobisher, Alida equiv., Tilston) horizons in the Williston Basin core area. In aggregate, the conventional properties bring more than 75 horizontal locations that can be methodically drilled as oil prices improve in order to deliver stable (or if desired, growing) non-ASP oil production volumes for many years.

2016 Outlook (1)

Zargon's 2016 total capital budget has been reduced to $7 million, of which approximately $4.5 million remains to be spent in the remaining three quarters. This remaining 2016 capital budget will be allocated $1.5 million to conventional expenditures, $2.7 million for ASP chemicals and $0.3 million for ASP exploitation expenditures. The 2016 drilling program does not anticipate the drilling of either conventional oil exploitation or Little Bow ASP wells.

Although Zargon's 2016 first quarter funds flow from operating activities were a negative $0.3 million, recent oil prices have improved significantly from the first quarter lows, and funds flow from operations for the remainder of the year are anticipated to substantially exceed the remaining 2016 capital budget levels.

Production Guidance (1)

In the March 7, 2016 year end results press release, Zargon provided 2016 oil production guidance of 3,550 barrels of oil and liquids per day (including incremental ASP volumes). This rate incorporates 2,950 of oil per day (excluding Little Bow ASP) of conventional production plus 600 barrels of per day of Little Bow phase 1 oil production. Actual first quarter volumes essentially met guidance and were 3,503 barrels of oil and liquids per day. Zargon set the 2016 natural gas production guidance at 3.6 million cubic feet per day, a level that was exceeded by actual first quarter volumes of 4.0 million cubic feet per day.

For the remainder of 2016, Zargon anticipates that increasing oil production volumes from the Little Bow ASP project will offset the impact of the 12 percent base decline from the conventional oil properties, and will maintain an average production rate of 3,550 barrels of oil per day. This forecast assumes that no additional wells are drilled on either the Little Bow ASP or conventional oil exploitation properties. Natural gas volumes are forecasted to average 3.5 million cubic feet per day for the remainder of 2016.

Strategic Alternatives Process Update (1)

Last year, Zargon announced the formation of a Special Board Committee (the "Committee") to examine alternatives that would maximize shareholder value in a manner that would recognize the Company's fundamental inherent value related to Zargon's long-life, low-decline conventional oil assets and the significant long term oil potential related to the Little Bow ASP project. Scotia Waterous Inc. ("Scotia") is the financial adviser for the Committee.

This continuing financial review includes, but is not limited to, a financing, merger or other business combination, sale of the Company or a portion of the company's business or assets, or any combination thereof, as well as the continued execution of its business plan. The ongoing review has incorporated an analysis of improving market trends and tone, plus encouraging cost trends and ASP results. To this end, Scotia, on behalf of the Company has recently initiated a broad marketing process involving potential domestic and foreign purchasers, which will include a data room to allow qualified parties to access data concerning the Company's operations. Additional information regarding Zargon and the corporate marketing process is available on our website at www.zargon.ca. The Company expects to provide updated disclosure regarding this Scotia strategic alternatives process with the 2016 second quarter results that will be reported in August.

(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 2016 first quarter financial results and should be read in conjunction with the unaudited interim consolidated financial statements and related notes for the three months ended March 31, 2016 and the audited consolidated financial statements and related notes for the year ended December 31, 2015. 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 ("Mcfe") 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 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 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 per boe, other expense per boe and current tax 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 May 10, 2016, and contains forward-looking statements including:

- *our expectations on reducing operating and transportation expenses and general and administrative costs referred to under the heading “Ongoing Cost Reduction Initiatives”;*
- *our expectations for our plans with respect to our Little Bow ASP project referred to under the headings “Little Bow Alkaline Surfactant Polymer (“ASP”) Project Update”, “2016 Outlook”, “Production Guidance” and “Strategic Alternatives Process Update”;*
- *our expectations for our production referred to under the heading “Production Guidance”;*
- *our strategic alternatives process referred to under the headings “Strategic Alternatives Process Update” and “Outlook”;*
- *our expectations for our remaining 2016 capital budget program referred to under the headings “2016 Outlook”, “Production Guidance”, “Liquidity and Capital Resources” and “Outlook”;*
- *our expectations for our funds flow from operating activities referred to under the heading “2016 Outlook”;*
- *our borrowing base referred to under the heading “Liquidity and Capital Resources”;*
- *our dividend policy referred to under the heading “Liquidity and Capital Resources”; 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. 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 May 10, 2016.

FINANCIAL & OPERATING RESULTS

Petroleum and Natural Gas Sales

($ millions)	**2016**	2015	Percent Change
	Three months ended March 31,		
Petroleum sales	**9.01**	14.94	(40)
Natural gas sales	**0.60**	1.47	(59)
Petroleum and natural gas sales	**9.61**	16.41	(41)

First quarter 2016 gross petroleum and natural gas sales of $9.61 million were 41 percent below the $16.41 million in the first quarter of 2015 due to significantly lower oil and natural gas prices and reductions in oil and natural gas production volumes.

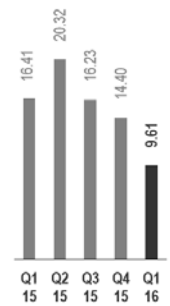
First quarter 2016 realized oil and liquids field prices averaged $28.27 per barrel before the impact of financial risk management contracts and were 33 percent lower than the $42.26 per barrel recorded in the 2015 first quarter. Zargon's crude oil field price differential from the Edmonton par price increased to $12.78 per barrel in the first quarter of 2016 compared to $10.46 per barrel in the first quarter of 2015. Natural gas field prices received averaged $1.64 per thousand cubic feet in the first quarter of 2015, a 47 percent decrease from the 2015 first quarter prices.

Pricing

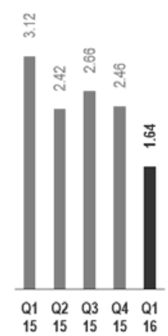
Average for the period	**2016**	2015	Percent Change
	Three Months Ended March 31,		
Natural Gas:			
NYMEX average daily spot price ($US/mmbtu)	**1.98**	2.87	(31)
AECO average daily spot price ($Cdn/mmbtu)	**1.83**	2.75	(33)
Zargon realized field price before the impact of financial risk management contracts ($Cdn/mcf)	**1.64**	3.12	(47)
Zargon realized field price before the impact of physical and financial risk management contracts ($Cdn/mcf)	**1.64**	2.64	(38)
Zargon realized natural gas field price differential before the impact of physical and financial risk management contracts ($Cdn/mcf)	**0.19**	0.11	
Crude Oil:			
WTI ($US/bbl)	**33.45**	48.63	(31)
Edmonton par price ($Cdn/bbl)	**41.05**	52.72	(22)
Zargon realized field price before the impact of financial risk management contracts ($Cdn/bbl)	**28.27**	42.26	(33)
Zargon realized field price after the impact of financial risk management contracts ($Cdn/bbl)	**33.03**	64.93	(49)
Zargon realized oil field price differential [1]	**12.78**	10.46	

(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).

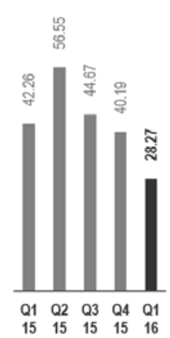
Petroleum and Natural Gas Revenue
($ millions)



Natural Gas Prices
($/mcf)



Oil and Liquids Prices
($/bbl)



Volumes

Oil and liquids production volumes during the 2016 first quarter were 3,503 barrels per day, an 11 percent decrease from the 2015 first quarter rate of 3,928 barrels per day. The production decrease is due to natural occurring production declines resulting from the significant reduction in conventional capital spending. Natural gas production volumes decreased 23 percent in the 2016 first quarter to 4.04 million cubic feet per day compared to 5.24 million cubic feet per day in the 2015 first quarter. The production decrease is due to naturally occurring production declines and the shut-in of uneconomic wells.

Production by Core Area

Three Months Ended March 31,		**2016**			2015	
	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	**704**	**1.70**	**987**	852	2.60	1,286
Alberta Plains South	**1,227**	**2.00**	**1,560**	1,225	2.29	1,607
Williston Basin	**1,572**	**0.34**	**1,629**	1,851	0.35	1,909
	3,503	**4.04**	**4,176**	3,928	5.24	4,802

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 may also enter into interest rate swaps.

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/(loss) and their fair value is reflected in "derivative assets" or "derivative liabilities" on the consolidated balance sheets.

In the 2016 first quarter, higher contract prices versus WTI oil prices resulted in a net realized gain on derivatives of $1.44 million compared to an $8.33 million net realized gain in the first quarter of 2015.

The unrealized loss on derivatives of $0.93 million in the first quarter of 2016 was comprised of oil contract losses of $1.03 million and interest rate swap gains of $0.10 million, compared to a net $5.94 million loss in the first quarter of 2015. 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 10 and 11 to the unaudited interim consolidated financial statements.

Royalties

	Three months ended March 31,		
($ millions)	**2016**	2015	Percent Change
Royalties	**1.12**	2.50	(55)
Percentage of revenue	**11.6%**	15.2%	

Royalties are inclusive of the Saskatchewan Resource Surcharge ("SRC"). The variations in royalty rates generally track changes in production and volumes. First quarter of 2016 royalties were 11.6 percent of gross sales compared to 15.2 percent in the first quarter of 2015.

Operating Expenses and Transportation Expenses

($ millions)	**2016**	2015	Percent Change
	Three months ended March 31,		
Operating expenses	**7.04**	9.20	(23)
Transportation expenses	**0.08**	0.32	(75)
Total expenses	**7.12**	9.52	(25)
Total expenses ($/boe)	**18.75**	22.02	(15)

Compared to the prior year's first quarter, operating expenses and transportation expenses in the 2016 first quarter are down on a total dollar basis and on a per barrel of oil equivalent basis due to general cost containment initiatives, lower electricity costs and the closure of the Stettler field office. Additional cost reductions came from the shut-in of higher cost properties.

Operating Netbacks

Three Months Ended March 31,	**2016**		2015	
	Oil and Liquids ($/bbl)	**Natural Gas ($/mcf)**	Oil and Liquids ($/bbl)	Natural Gas ($/mcf)
Sales	**28.27**	**1.64**	42.26	3.12
Royalties	**(3.37)**	**(0.12)**	(6.62)	(0.33)
Realized gain on derivatives	**4.76**	**–**	22.67	0.79
Operating expenses	**(19.10)**	**(2.58)**	(22.08)	(2.96)
Transportation expenses	**(0.27)**	**–**	(0.89)	–
Operating netbacks	**10.29**	**(1.06)**	35.34	0.62

General & Administrative ("G&A") Expenses

($ millions)	**2016**	2015	Percent Change
	Three months ended March 31,		
G&A expenses	**1.70**	2.75	(38)
G&A expenses ($/boe)	**4.48**	6.36	(30)

G&A expenses per barrel of oil equivalent were lower in the first quarter of 2016 primarily due to reductions in salaries and wages from staff reductions that occurred in 2015. Zargon has focused on reducing G&A expenses during the current period of low commodity prices.

Transaction Costs

Transaction costs for the 2016 first quarter were $0.03 million and related to Zargon's ongoing strategic alternatives review. The comparative 2015 first quarter costs were unchanged at $0.03 million.

Interest and Financing Charges on Long Term Bank Debt

Zargon reduced its syndicated committed credit facilities from $110 million to $88 million after the Company's semi-annual review was completed on November 10, 2015. This reduction is primarily a result of lower commodity prices. The next renewal date is June 22, 2016. 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 2016 first quarter were $0.63 million, a five percent increase from $0.60 million in the first quarter of 2015. The increase in interest and financing charges resulted from higher average borrowing levels partially offset by a lower effective interest rate compared to the first quarter of 2015.

Interest on Convertible Debentures

Zargon has borrowings through its convertible debentures, which were issued in May 2012 and mature on June 30, 2017. Zargon may redeem the convertible debentures with cash or through the issuance of Zargon common shares priced at 95 percent of the then current Zargon share price. 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 first quarter of 2016 were unchanged compared to the first quarter of 2015.

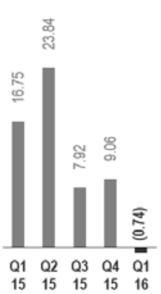
Current Tax

The current tax recovery for the 2016 first quarter was $0.01 million and when compared to the 2015 first quarter, the current tax recovery decreased by $0.23 million. Total corporate tax pools as at March 31, 2016 are approximately $279 million, unchanged from the comparable $279 million of tax pools available to Zargon at December 31, 2015.

Estimated Tax Pools

($ millions)	March 31, 2016
Canadian oil and natural gas property expenses	**1**
Canadian development expenses	**31**
Canadian exploration expenses	**42**
Capital cost allowance	**58**
Non-capital losses	**144**
US tax pools	**1**
Other	**2**
Estimated tax pools	**279**

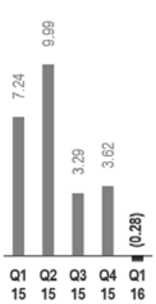
Funds Flow Netbacks
($/boe)



Corporate Netbacks

	Three Months Ended March 31,	
($/boe)	**2016**	2015
Petroleum and natural gas sales	**25.30**	37.98
Royalties	**(2.95)**	(5.78)
Realized gain on derivatives	**3.79**	19.28
Operating expenses	**(18.52)**	(21.29)
Transportation expenses	**(0.23)**	(0.73)
Operating netbacks	**7.39**	29.46
General and administrative expenses	**(4.48)**	(6.36)
Transaction costs	**(0.08)**	(0.08)
Interest and financing charges	**(1.64)**	(1.38)
Interest on convertible debentures	**(2.27)**	(2.00)
Asset retirement (expenditures)/recovery	**0.31**	(3.44)
Current tax recovery	**0.03**	0.55
Funds flow netbacks	**(0.74)**	16.75

Funds Flow from Operating Activities
($ millions)



Depletion and Depreciation Expense

Depletion and depreciation expense for the first quarter of 2016 decreased 27 percent at $6.37 million compared to $8.72 million in the first quarter of 2015. On a per barrel of oil equivalent basis, the depletion and depreciation rates were $16.76 and $20.18 for the first quarter of 2016 and the first quarter of 2015, respectively. When compared to the first quarter of 2015, the decreased depletion rate is primarily due to the impact of the impairment of property, plant and equipment in 2015. The 2015 calendar year depletion and depreciation rate was $19.94 per barrel of oil equivalent.

Accretion of Asset Retirement Obligations and Convertible Debentures

The accretion expense of asset retirement obligations for the first three months of 2016 was $0.49 million, a nine percent decrease from the first three months of 2015. 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 2016 first quarter is $0.37 million compared to $0.34 million in the 2015 first quarter.

Shared-based Compensation

Expensing of share-based compensation in the first quarter of 2016 totalled $0.15 million, which is slightly higher than the $0.11 million incurred in the first quarter of 2015.

Unrealized Foreign Exchange

The Company had an unrealized foreign exchange loss of $0.57 million during the first quarter of 2016 compared to a gain of $0.47 million in the 2015 first 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.

Exploration and Evaluation Expenses

Non-cash exploration and evaluation expenses for the 2016 first quarter of $0.04 million compared to first quarter of 2015 expenses of nil. Exploration and evaluation expenses are primarily related to undeveloped land expiries. The 2016 first quarter exploration and evaluation expense primarily related to expiries in North Dakota.

Deferred Tax

The deferred tax recovery for the first quarter of 2016 was $0.49 million compared to a recovery of $1.57 million in the first quarter of 2015. The deferred tax recovery is a result of the net loss in the quarter.

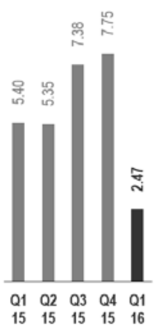
Funds Flow from Operating Activities

Funds flow from operating activities in the 2016 first quarter was a negative $0.28 million and was $7.52 million, or 104 percent lower than the prior year first quarter. The decrease in funds flow compared to the prior year first quarter was primarily a result of decreased revenue from lower oil and natural gas prices which was partially offset by decreased operating expenses, lower royalties, lower G&A expenses and a gain on realized derivatives.

Net Loss

A net loss of $8.82 million for the 2016 first quarter was $3.94 million higher than the $4.88 million net loss in the 2015 first quarter, largely due to decreased revenue and lower realized derivative gains offset by lower unrealized derivatives losses and depletion and depreciation. 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 2016 first quarter net loss was $0.29, compared to a net loss of $0.16 from the 2015 first quarter.

Net Capital Expenditures
($ millions)



Capital Expenditures

	Three Months Ended March 31,	
($ millions)	**2016**	2015
Undeveloped land	**0.46**	0.40
Geological and geophysical (seismic)	**0.04**	0.05
Drilling and completion of wells	**0.01**	0.52
Well equipment and facilities	**(0.08)**	0.22
ASP project and exploitation costs	**0.18**	1.41
ASP chemical costs	**1.82**	2.84
Exploration and development	**2.43**	5.44
Property acquisitions	**0.04**	0.03
Property dispositions	**–**	(0.03)
Net property acquisitions	**0.04**	–
Total net capital expenditures excluding administrative assets	**2.47**	5.44
Administrative assets	**–**	(0.04)
Total net capital expenditures	**2.47**	5.40

LIQUIDITY AND CAPITAL RESOURCES

Total net capital expenditures (including net property acquisitions) totalled $2.47 million in the first quarter of 2016 and were 54 percent lower than the same period in 2015. Field expenditures of $2.43 million for the first quarter of 2016 were 55 percent lower than the 2015 first quarter. The first quarter 2016 field capital expenditures (excluding net property acquisitions) were allocated to Alberta Plains North - $0.27 million, Alberta Plains South - $2.26 million and Williston Basin - $0.10 million recovery and included the drilling of nil net wells, unchanged from the first quarter of 2015.

Included in the Alberta Plains South capital expenditures is the $2.00 million incurred on the Little Bow ASP project. Of the total ASP amount, $0.18 million was spent on project and exploitation costs while $1.82 million was spent on chemical costs for the facility.

At March 31, 2016, the Company's combined debt net of working capital (excluding unrealized derivative assets/liabilities) was $124.37 million, which compares to $121.06 million of net debt at the end of December 31, 2015. The increase in net debt was primarily due to lower commodity prices and consequently lower revenue and funds flow. The $124.37 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 Company's borrowing base is determined and re-determined by our lenders based on our reserves, commodity prices, applicable discount rate and other factors as determined by our lenders. A material decline in commodity prices could reduce our borrowing base, thereby reducing the funds available to us under our credit facilities which could result in a portion, or all, of our bank indebtedness being required to be repaid.

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

Zargon's operational results and financial condition, and, therefore, the funds available to be allocated to capital expenditures, are dependent on the prices received for oil and natural gas production. First quarter 2016 Zargon field oil prices were 38 percent lower than the average 2015 field oil price, which had dropped 45 percent from 2014 field price levels. These lower oil prices have significantly reduced revenues and will continue to negatively affect revenues, funds flow and capital expenditures in the future unless prices recover.

Cash Dividends Analysis

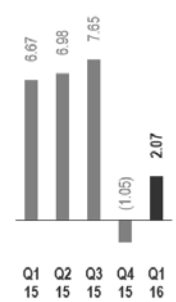
	Three Months Ended March 31,	
($ millions)	**2016**	2015
Cash flows from operating activities	**2.07**	6.67
Net loss	**(8.82)**	(4.88)
Actual cash dividends paid or payable relating to the period	**–**	(2.72)
Excess of cash flows from operating activities over cash dividends paid	**–**	3.95
Excess (shortfall) of net earnings over cash dividends paid	**–**	(7.60)

(1) Cash dividends were suspended after the October 2015 dividend paid on November 16, 2015.

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.

In response to continuing weakness in both spot and forward commodity price markets and increased uncertainty in the capital markets, the Board of Directors of Zargon on November 11, 2015 suspended Zargon's monthly dividend after the November 16, 2015 payment.

Cash Flows from Operating Activities
($ millions)



For the quarter ended March 31, 2016, net capital expenditures totalled $2.47 million, which was $0.40 million higher than the cash flows from operating activities (after changes in non-cash working capital) of $2.07 million. For the quarter ended March 31, 2015, cash dividends and net capital expenditures totalled $8.12 million, which was $1.45 million higher than the cash flows from operating activities (after changes in non-cash working capital) of $6.67 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 capital expenditures with its cash flows from operating activities; however, it may continue to fund growth through additional debt and equity issuances. In the crude oil and natural gas industry, because of the nature of reserve reporting, the natural reservoir declines and the risks involved in capital investment, it is not possible to distinguish between capital spent on maintaining productive capacity and capital spent on growth opportunities. Therefore, maintenance capital is not disclosed separately from development capital spending.

At May 10, 2016, Zargon Oil & Gas Ltd. had 30.470 million common shares outstanding. Pursuant to the share award plan, there are currently an additional 0.814 million common share awards issued and outstanding.

Capital Sources and Uses

	Three Months Ended March 31,	
($ millions)	**2016**	2015
Funds flow from/(used in) operating activities	**(0.28)**	7.24
Change in long term bank debt	**4.36**	7.14
Cash dividends to shareholders	**–**	(2.72)
Changes in working capital and other	**(1.61)**	(6.26)
Total capital sources	**2.47**	5.40

(1) Cash dividends were suspended after the October 2015 dividend paid on November 16, 2015.

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 2016 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 first quarter of 2016.

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

Since mid-2014, oil prices have declined precipitously to unexpected levels and as a result, Zargon's current revenues and cash flows are significantly reduced. During these challenging times, Zargon will seek to improve cash flows by reducing all costs while restricting capital programs to only necessary programs. Additionally, on August 13, 2015, Zargon announced the initiation of a process to identify and consider strategic and financial alternatives available to the Company with the ultimate goal of maximizing shareholder value.

SUMMARY OF QUARTERLY RESULTS

	2015				**2016**
	Q1	Q2	Q3	Q4	**Q1**
Petroleum and natural gas sales ($ millions)	16.41	20.32	16.23	14.40	**9.61**
Net loss ($ millions)	(4.88)	(3.76)	(41.16)	(56.34)	**(8.82)**
Net loss per diluted share ($)	(0.16)	(0.12)	(1.36)	(1.86)	**(0.29)**
Funds flow from/(used in) operating activities ($ millions)	7.24	9.99	3.29	3.62	**(0.28)**
Funds flow from/(used in) operating activities per diluted share ($)	0.24	0.33	0.11	0.12	**(0.01)**
Cash flows from operating activities ($ millions)	6.67	6.98	7.65	(1.05)	**2.07**
Cash flows from operating activities per diluted share ($)	0.22	0.23	0.25	(0.03)	**0.07**
Cash dividends ($ millions) (1)	2.72	2.73	0.91	0.30	**–**
Cash dividends declared per common share ($) (1)	0.09	0.09	0.03	0.01	**–**
Net capital expenditures ($ millions)	5.40	5.35	7.38	7.75	**2.47**
Total assets ($ millions)	377.16	369.47	325.64	263.66	**255.14**
Long term bank debt ($ millions)	49.91	50.80	51.98	60.24	**64.59**
Convertible debentures ($ millions) (2)	57.50	57.50	57.50	57.50	**57.50**
Net debt	113.80	111.99	116.96	121.06	**124.37**
Average daily oil and liquids production (bbl)	3,928	3,720	3,633	3,635	**3,503**
Average daily natural gas production (mmcf)	5.24	5.32	5.28	4.23	**4.04**
Average daily production (boe)	4,802	4,607	4,513	4,340	**4,176**
Average oil production weighting (%)	82	81	81	84	**84**
Average realized commodity field price before the impact of financial risk management contracts ($/boe)	37.98	48.46	39.08	36.05	**25.30**
Funds flow netback ($/boe)	16.75	23.84	7.92	9.06	**(0.74)**

(1) Cash dividends were suspended after the October 2015 dividend paid on November 16, 2015.

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

	2014			
	Q1	Q2	Q3	Q4
Petroleum and natural gas sales ($ millions)	40.26	40.86	37.41	27.35
Net earnings/(loss) ($ millions)	0.17	(2.02)	0.10	7.70
Net earnings/(loss) per diluted share ($)	0.01	(0.07)	–	0.19
Funds flow from operating activities ($ millions)	15.30	11.88	10.87	12.63
Funds flow from operating activities per diluted share ($)	0.50	0.39	0.35	0.41
Cash flows from operating activities ($ millions)	14.86	10.03	12.36	13.15
Cash flows from operating activities per diluted share ($)	0.49	0.33	0.40	0.43
Cash dividends ($ millions)	5.42	5.42	5.43	5.43
Cash dividends declared per common share ($)	0.18	0.18	0.18	0.18
Net capital expenditures/(dispositions) ($ millions)	15.48	13.37	6.09	(8.67)
Total assets ($ millions)	462.66	461.70	426.51	382.71
Long term bank debt ($ millions)	50.55	56.37	59.45	42.77
Convertible debentures ($ millions) (1)	57.50	57.50	57.50	57.50
Net debt	121.72	128.88	129.11	113.43
Average daily oil and liquids production (bbl)	4,320	4,096	4,194	4,150
Average daily natural gas production (mmcf)	14.05	14.77	11.16	6.43
Average daily production (boe)	6,662	6,558	6,054	5,222
Average oil production weighting (%)	65	62	69	79
Average realized commodity field price before the impact of financial risk management contracts ($/boe)	67.15	68.46	67.18	56.93
Funds flow netback ($/boe)	25.52	19.90	19.51	26.30

(1) 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, 2015, is available on the Company's SEDAR profile at www.sedar.com.

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

Calgary, Alberta
May 10, 2016

CONSOLIDATED BALANCE SHEETS

(unaudited)

($ thousands)	Notes	**March 31, 2016**	December 31, 2015
ASSETS			
Trade and other receivables		**5,035**	6,846
Deposits and prepaid expenses		**799**	1,177
Investment in marketable securities	10	**662**	662
Derivatives	10,11	**1,318**	2,344
Total current assets		**7,814**	11,029
Long term deposits		**167**	167
Property, plant and equipment, net	4	**225,283**	230,543
Intangible exploration and evaluation assets	5	**5,662**	5,713
Deferred tax assets		**16,212**	16,212
Total assets		**255,138**	263,664
LIABILITIES			
Trade and other payables		**8,773**	12,005
Derivatives	10,11	**123**	224
Total current liabilities		**8,896**	12,229
Long term bank debt	7	**64,594**	60,238
Convertible debentures		**55,499**	55,129
Asset retirement obligations	6	**78,369**	78,196
Deferred tax liabilities		**4,501**	5,291
Total liabilities		**211,859**	211,083
Commitments and contingencies	6,7,9,10,11		
EQUITY			
Shareholders' capital	8	**259,925**	259,149
Accumulated other comprehensive income		**4,619**	5,249
Contributed surplus	9	**11,571**	12,198
Equity component of debentures		**3,640**	3,640
Deficit		**(236,476)**	(227,655)
Total equity		**43,279**	52,581
Total equity and liabilities		**255,138**	263,664

See accompanying notes to the interim consolidated financial statements.

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

(unaudited)		Three Months Ended March 31,	
($ thousands, except per share amounts)	Notes	**2016**	2015
Petroleum and natural gas sales		**9,614**	16,414
Royalties		**(1,120)**	(2,496)
PETROLEUM AND NATURAL GAS REVENUE, NET OF ROYALTIES		**8,494**	13,918
Loss on unrealized derivatives	10,11	**(926)**	(5,940)
Gain on realized derivatives	10,11	**1,437**	8,330
GAIN ON DERIVATIVES		**511**	2,390
TOTAL INCOME		**9,005**	16,308
Operating		**7,036**	9,201
Transportation		**86**	316
General and administrative		**1,701**	2,749
Transaction costs		**29**	33
Exploration and evaluation	5	**42**	–
Loss on disposal of properties		**–**	2
Share-based compensation	9	**149**	114
Unrealized foreign exchange (gain)/loss		**566**	(468)
Depletion and depreciation		**6,369**	8,722
EXPENSES		**15,978**	20,669
LOSS BEFORE FINANCE EXPENSES AND INCOME TAXES		**(6,973)**	(4,361)
Interest and financing charges	7	**625**	597
Interest on convertible debentures		**863**	863
Accretion on convertible debentures		**370**	336
Accretion of asset retirement obligations	6	**488**	536
FINANCE EXPENSES		**2,346**	2,332
LOSS BEFORE INCOME TAXES		**(9,319)**	(6,693)
Current tax recovery		**(12)**	(237)
Deferred tax recovery		**(486)**	(1,572)
INCOME TAXES RECOVERY		**(498)**	(1,809)
NET LOSS FOR THE PERIOD		**(8,821)**	(4,884)
Currency translation adjustment recognized in other comprehensive income		**(630)**	1,752
OTHER COMPREHENSIVE EARNINGS/(LOSS) FOR THE PERIOD		**(630)**	1,752
TOTAL COMPREHENSIVE LOSS FOR THE PERIOD		**(9,451)**	(3,132)
NET LOSS PER SHARE			
Basic		**(0.29)**	(0.16)
Diluted		**(0.29)**	(0.16)

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(unaudited)

($ thousands)	Notes	Shareholders' Capital	Accumulated Other Comprehensive Income	Contributed Surplus	Equity Component of Convertible Debentures	Deficit	Total Equity
Balance at December 31, 2015		**259,149**	**5,249**	**12,198**	**3,640**	**(227,655)**	**52,581**
Net loss for the period		**–**	**–**	**–**	**–**	**(8,821)**	**(8,821)**
Share-based compensation	9	**–**	**–**	**149**	**–**	**–**	**149**
Exercise of share awards	8	**776**	**–**	**(776)**	**–**	**–**	**–**
Translation differences on foreign subsidiary		**–**	**(630)**	**–**	**–**	**–**	**(630)**
Balance at March 31, 2016		**259,925**	**4,619**	**11,571**	**3,640**	**(236,476)**	**43,279**
Balance at December 31, 2014		257,138	2,538	12,879	3,640	(114,855)	161,340
Net loss for the period		–	–	–	–	(4,884)	(4,884)
Dividends declared		–	–	–	–	(2,723)	(2,723)
Share-based compensation	9	–	–	114	–	–	114
Exercise of share awards	8	992	–	(992)	–	–	–
Cancellation of shares	8	(39)	–	111	–	–	72
Translation differences on foreign subsidiary		–	1,752	–	–	–	1,752
Balance at March 31, 2015		258,091	4,290	12,112	3,640	(122,462)	155,671

See accompanying notes to the interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)		Three Months Ended March 31,	
($ thousands)	Notes	**2016**	2015
OPERATING ACTIVITIES			
Net loss for the period		**(8,821)**	(4,884)
Adjustments for non-cash items:			
Loss on sale of properties		**–**	2
Loss on unrealized derivatives	10,11	**926**	5,940
Depletion and depreciation	4	**6,369**	8,722
Accretion of asset retirement obligations	6	**488**	536
Accretion of convertible debentures		**370**	336
Share-based compensation	9	**149**	114
Unrealized foreign exchange (gain)/loss		**566**	(468)
Deferred tax recovery		**(486)**	(1,572)
Exploration and evaluation expenses	5	**42**	–
Asset retirement (expenditures)/recovery	6	**116**	(1,486)
Funds flow from/(used in) operating activities		**(281)**	7,240
Changes in operating working capital		**2,348**	(575)
Net cash from operating activities		**2,067**	6,665
INVESTING ACTIVITIES			
Additions to property, plant and equipment	4	**(2,409)**	(5,406)
Additions to intangible exploration and evaluation assets	5	**(62)**	(30)
Proceeds on disposal of property, plant and equipment		**–**	34
Changes in investing working capital		**(3,952)**	(4,775)
Net cash used in investing activities		**(6,423)**	(10,177)
FINANCING ACTIVITIES			
Advances of bank debt		**4,356**	7,138
Cash dividends paid to shareholders		**–**	(2,723)
Changes in financing working capital		**–**	(903)
Net cash provided by financing activities		**4,356**	3,512
NET CHANGE IN CASH DURING THE PERIOD AND CASH, END OF PERIOD		**–**	–

See accompanying notes to the interim consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the three months ended March 31, 2016, with comparative figures for 2015 (unaudited).

1. REPORTING ENTITY

Zargon Oil & Gas Ltd. ("the Company" or "Zargon") is a publicly traded corporation incorporated in Canada with its head office located at Suite 700, 333-5th Avenue SW, Calgary, Alberta. The interim consolidated financial statements of the Company as at and for the period ended March 31, 2016 and for its 2015 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 month period ended March 31, 2016 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, 2015. 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 month period ended March 31, 2016 should be read in conjunction with the annual consolidated financial statements for the year ended December 31, 2015. These consolidated financial statements were approved and authorized for issue by the Board of Directors on May 10, 2016.

(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:

No new or amended standards were adopted by the Company for the interim period.

(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, 2018 with early adoption permitted. The Company has not yet determined the impact on the Company’s consolidated financial statements.
- IFRS 16 “Leases”, was issued by IASB in January 2016, which replaces IAS 17 “Leases”. For lessees applying IFRS 16, a single recognition and measurement model for leases would apply, with required recognition of assets and liabilities for most leases. The standard will come into effect for annual periods beginning on or after January 1, 2019, with earlier adoption permitted if the entity is also applying IFRS 15 “Revenue from Contracts with Customers”. The Company has not yet determined the impact on the Company’s consolidated financial statements.

4. PROPERTY, PLANT AND EQUIPMENT

($ thousands)

Cost, December 31, 2015	**448,006**
Accumulated depletion and depreciation	**(217,463)**
Net carrying amount, December 31, 2015	**230,543**
Additions	**2,409**
Exchange differences	**(1,300)**
Depletion and depreciation	**(6,369)**
Net carrying amount, March 31, 2016	**225,283**
Cost, March 31, 2016	**447,966**
Accumulated depletion and depreciation	**(222,683)**
Net carrying amount, March 31, 2016	**225,283**

5. INTANGIBLE EXPLORATION AND EVALUATION ASSETS

($ thousands)	
Cost, December 31, 2015	**5,713**
Additions	**62**
Exploration and evaluation expense	**(42)**
Exchange differences	**(71)**
Cost, March 31, 2016	**5,662**

6. ASSET RETIREMENT OBLIGATIONS

($ thousands)	
Balance at December 31, 2015	**78,196**
Foreign exchange and other	**(431)**
Asset retirement obligations recovered during the period	**116**
Accretion	**488**
Balance at March 31, 2016	**78,369**

The asset retirement obligations were calculated using a discount factor of 2.50 percent (December 31, 2015 – 2.50 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, 2015 – two percent) used in the calculation of the present value of the asset retirement obligation remains unchanged.

7. LONG TERM BANK DEBT

On June 18, 2015, Zargon amended and renewed its syndicated credit facilities, the result of which was the reduction of the available facilities and borrowing base to $110 million. The syndicated committed credit facilities were reduced to $88 million after the Company's semi-annual review was completed on November 10, 2015. 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 22, 2016. 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 March 31, 2016, $64.59 million (December 31, 2015 - $60.24 million) had been drawn on the syndicated committed credit facilities with any unused amounts subject to standby fees. In the normal course of operations Zargon enters into various letters of credit. At March 31, 2016, the approximate value of outstanding letters of credit totalled $0.95 million (December 31, 2015 - $0.98 million). The letters of credit reduce the amount of Zargon's available credit facilities to $22.46 million at March 31, 2016 (December 31, 2015 - $26.78 million).

Zargon reviews its compliance with its bank debt covenants on a quarterly basis and is in compliance as at March 31, 2016.

8. SHARE CAPITAL

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

Common Shares

	Three Months Ended March 31, 2016	
(thousands)	Number of Shares	Amount ($)
Balance, as at December 31, 2015	**30,366**	**259,149**
Share awards exercised	**104**	**–**
Share-based compensation recognized on exercise of share awards	**–**	**776**
Balance, as at March 31, 2016	**30,470**	**259,925**

9. 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. The Company is authorized to issue up to an aggregate of 2.50 million share awards; however, the number of shares reserved for issuance upon exercise of the awards shall not, at any time, exceed 10 percent of the aggregate number of the total outstanding shares.

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 11 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:

	Three Months Ended March 31, 2016
	Number of Share Awards (thousands)
Outstanding, as at December 31, 2015	**908**
Share awards granted	**21**
Share awards exercised	**(104)**
Share awards forfeited	**(11)**
Outstanding, as at March 31, 2016	**814**

Share-based Compensation

The share awards for the three months ended March 31, 2016, resulted in share-based compensation of $0.15 million (2015 - $0.11 million).

Compensation expense associated with share awards granted is recognized in earnings over the vesting period with a corresponding increase in contributed surplus. The exercise of share awards 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 March 31, 2016	2015
Weighted average number of common shares – basic	**30,440**	30,245
Weighted average number of common shares – diluted	**30,440**	30,245

No dilution amounts for the three months ended March 31, 2016 and 2015 were added to the weighted average number of shares outstanding during the period in the calculation of diluted per share amounts.

The convertible debenture could potentially dilute basic earnings per share, but were not included in the calculation of diluted earnings per share because they are antidilutive for the three months ended March 31, 2016 and 2015.

10. 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:

	March 31, 2016		December 31, 2015	
(thousands)	**Carrying Value ($)**	**Fair Value ($)**	Carrying Value ($)	Fair Value ($)
Loans and receivables:				
Trade and other receivables	**5,035**	**5,035**	6,846	6,846
Fair value through profit and loss:				
Derivative assets	**1,318**	**1,318**	2,344	2,344
Derivative liabilities	**123**	**123**	224	224
Fair value through other comprehensive income:				
Investment in marketable securities	**662**	**662**	662	662
Other liabilities:				
Trade and other payables	**8,773**	**8,773**	12,005	12,005
Long term bank debt	**64,594**	**64,594**	60,238	60,238
Convertible debentures	**55,499**	**19,838**	55,129	23,587

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 financial instruments 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 consolidated 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 March 31, 2016, 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 may enter 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 March 31, 2016 debt pricing levels, the increase or decrease in net earnings for the year for each one percent change in interest rates would amount to $0.16 million (March 31, 2015 - $0.12 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 $0.05 million (March 31, 2015 - $0.08 million) increase or decrease in net earnings for the period ended March 31, 2016. 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 March 31, 2016, approximately 39 percent (December 31, 2015 - 38 percent) was owing from two companies and Zargon anticipates full collection.

The Company's allowance for doubtful accounts at March 31, 2016 was $0.15 million (December 31, 2015 - $0.15 million). During 2016, 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 March 31, 2016, $0.52 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 March 31, 2016, Zargon had available unused committed bank credit facilities of approximately $22.46 million compared to $26.78 million at December 31, 2015.

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	**8,773**	**–**	**8,773**
Derivative liabilities	**123**	**–**	**123**
Long term bank debt	**–**	**64,594**	**64,594**
Interest on convertible debentures	**3,450**	**1,725**	**5,175**
Convertible debentures (1)	**–**	**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 $0.23 million (March 31, 2015 – $0.67 million) for oil risk management contracts impacting net earnings for the three months ended March 31, 2016, respectively.

11. 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 income/(loss) for the first three months of 2016 was $0.93 million and the unrealized loss for the first three months of 2015 was $5.94 million. The realized gain on the statement of earnings/(loss) and comprehensive income/(loss) for the first three months of 2016 was $1.44 million and the realized gain for the first three months of 2015 was $8.33 million.

As at March 31, 2016, 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 ($ thousands)
Oil swaps	500 bbl/d	$79.30 Cdn/bbl	Apr. 1/16 – Jun. 30/16	1,318
Total Fair Market Value, Commodity Price Financial Contracts				**1,318**

Oil swaps are settled against the NYMEX WTI pricing index.

Interest Rate Risk Management Contracts:

	Notional Value	Interest Rate (1)	Range of Terms	Fair Market Value Liability ($ thousands)
Interest rate swaps	$20,000,000/month	1.640%	Apr. 1/16 – Jul. 26/16	(51)
	$20,000,000/month	1.731%	Apr. 1/16 – Aug. 26/16	(72)
Total Fair Market Value, Interest Rate Financial Contracts				**(123)**

(1) Excludes the current stamping fee of 2.25% for each swap.

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

CORPORATE INFORMATION

BOARD OF DIRECTORS

Craig H. Hansen
Calgary, Alberta

K. James Harrison (2)
Chairman of the Board
Oakville, Ontario

Kyle D. Kitagawa (1)
Calgary, Alberta

Geoffrey C. Merritt (1)
Calgary, Alberta

Jim Peplinski (1) (2)
Calgary, Alberta

Ron Wigham (2)
Calgary, Alberta

Grant A. Zawalsky (2)
Calgary, Alberta

OFFICERS

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President and Chief Executive 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

Robert T. Moriyama
Vice President, Enhanced Recovery

Jeffrey N. Post
Chief Financial Officer

(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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