

ZION OIL & GAS INC  
Form 10-Q  
September 14, 2006

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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FORM 10-QSB

(Mark One)

☒ Quarterly report pursuant to Section 13 or 15(d) of the Securities

Exchange Act of 1934

For the quarterly period ended March 31, 2006

OR

☐ Transition report pursuant to Section 13 or 15(d) of the Securities

Exchange Act of 1934

Commission file number 333-131275

ZION OIL & GAS, INC.

(Name of Small Business Issuer as Specified in Its Charter)

Delaware

(State or other Jurisdiction

of Incorporation or Organization)

20-0065053

(I.R.S. Employer

Identification No.)

6510 Abrams Rd., Suite 300

Dallas, TX 75231

(Address of Principal Executive Offices)

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(214) 221-4610

(Issuer's Telephone Number, Including Area Code)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☐ No ☒

The Issuer had

8,031,288 shares of common stock outstanding as of September 1, 2006.

Transitional Small Business Disclosure Format (Check one): Yes ☐ No ☒

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**ZION OIL & GAS, INC.**

(A Development Stage Company)

**INTERIM FINANCIAL STATEMENTS**

**FOR**

**THE THREE MONTHS ENDING**

**MARCH 31, 2006**

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Zion Oil & Gas, Inc.

(A Development Stage Company)

Balance Sheets

|                           | March 31,           |
|---------------------------|---------------------|
|                           | December 31,        |
| ASSETS                    |                     |
|                           | 2006                |
|                           | 2005                |
|                           | <u>(Unaudited)</u>  |
|                           | <u>(Audited)</u>    |
|                           | <u>As restated*</u> |
|                           | <u>As restated*</u> |
| Current assets            |                     |
| Cash and cash equivalents |                     |
|                           | \$ 501,385          |

|                                                        |                  |
|--------------------------------------------------------|------------------|
|                                                        | \$ 1,141,029     |
| Inventories                                            |                  |
|                                                        | 149,801          |
|                                                        | 149,801          |
| Prepaid expenses and other                             |                  |
|                                                        | 21,125           |
|                                                        | 25,396           |
| Deferred offering costs                                |                  |
|                                                        | 205,515          |
|                                                        | 126,030          |
| Deferred financing costs                               |                  |
|                                                        | 11,255           |
|                                                        | 19,695           |
| Refundable value added tax                             |                  |
|                                                        | <u>11,469</u>    |
|                                                        | <u>29,401</u>    |
| Total current assets                                   |                  |
|                                                        | <u>900,550</u>   |
|                                                        | <u>1,491,352</u> |
| Unproved oil and gas properties, full cost method      |                  |
|                                                        | <u>7,929,797</u> |
|                                                        | <u>7,692,500</u> |
| Property and equipment                                 |                  |
| Net of accumulated depreciation of \$8,953 and \$5,843 |                  |
|                                                        | <u>56,031</u>    |
|                                                        | <u>48,852</u>    |

Other assets

Assets held for severance benefits

7,451

6,544

Total other assets

&nbsp;7,451

&nbsp;6,544

Total assets

\$ 8,893,829

\$ 9,239,248

# LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities

Notes payable to related parties

\$ 81,000

\$ 81,000

Accounts payable

124,811

619,257

Accrued liabilities

&nbsp;224,341

&nbsp;292,001

Total current liabilities

&nbsp;430,152

&nbsp;992,258

Notes payable to related parties less current maturities

30,500

|                                                                                                |                     |
|------------------------------------------------------------------------------------------------|---------------------|
|                                                                                                | 31,000              |
| Provision for severance pay                                                                    |                     |
|                                                                                                | 51,359              |
|                                                                                                | 48,318              |
| Deferred officers compensation                                                                 |                     |
|                                                                                                | 1,138,383           |
|                                                                                                | 929,007             |
| Stockholders' equity                                                                           |                     |
| Common stock, par value \$.01; 20,000,000 shares authorized;                                   |                     |
| March 31, 2006 - 7,777,288 shares; December 31, 2005 - 7,705,288 shares issued and outstanding |                     |
|                                                                                                | 77,773              |
|                                                                                                | 77,053              |
| Additional paid in capital                                                                     |                     |
|                                                                                                | 12,482,511          |
|                                                                                                | 11,991,988          |
| Deficit accumulated in development stage                                                       |                     |
|                                                                                                | <u>(5,316,849)</u>  |
|                                                                                                | <u>(4,830,376)</u>  |
| Total stockholders' equity                                                                     |                     |
|                                                                                                | <u>7,243,435</u>    |
|                                                                                                | <u>7,238,665</u>    |
| Total liabilities and stockholders equity                                                      |                     |
|                                                                                                | <u>\$ 8,893,829</u> |
|                                                                                                | <u>\$ 9,239,248</u> |

\*Restated (see Note 3)

The accompanying notes are an integral part of these statements.

ZION OIL & GAS, INC.  
(A Development Stage Company)  
Statements of Operations (Unaudited)

|                                                            | Three-month<br>period ended<br><u>March 31, 2006</u><br><u>As restated*</u> | Three-month<br>period ended<br><u>March 31, 2005</u><br><u>As restated*</u> | Period from<br>April 6, 2000<br>(inception)<br><u>to March 31, 2006</u><br><u>As restated*</u> |
|------------------------------------------------------------|-----------------------------------------------------------------------------|-----------------------------------------------------------------------------|------------------------------------------------------------------------------------------------|
| Revenue                                                    | \$ -                                                                        | \$ -                                                                        | \$ -                                                                                           |
| General and administrative expenses                        |                                                                             |                                                                             |                                                                                                |
| Legal and professional                                     | 142,101                                                                     | 103,035                                                                     | 2,136,896                                                                                      |
| Salaries                                                   | 233,836                                                                     | 41,232                                                                      | 1,695,854                                                                                      |
| Other                                                      | <u>100,960</u>                                                              | <u>92,951</u>                                                               | <u>809,107</u>                                                                                 |
|                                                            | <u>476,897</u>                                                              | <u>237,218</u>                                                              | <u>4,641,857</u>                                                                               |
| Loss from operations                                       | (476,897)                                                                   | (237,218)                                                                   | (4,641,857)                                                                                    |
| Other income (expense)                                     |                                                                             |                                                                             |                                                                                                |
| Termination of initial public offering                     | -                                                                           | -                                                                           | (507,380)                                                                                      |
| Interest expense, net                                      | <u>(9,576)</u>                                                              | <u>(725)</u>                                                                | <u>(167,612)</u>                                                                               |
| Loss before income taxes                                   | (486,473)                                                                   | (237,943)                                                                   | (5,316,849)                                                                                    |
| Income tax                                                 | <u>-</u>                                                                    | <u>-</u>                                                                    | <u>-</u>                                                                                       |
| Net loss                                                   | <u>\$ (486,473)</u>                                                         | <u>\$ (237,943)</u>                                                         | <u>\$ (5,316,849)</u>                                                                          |
| Net loss per share of common stock-                        |                                                                             |                                                                             |                                                                                                |
|                                                            | <u>\$ (0.06)</u>                                                            | <u>\$ (0.04)</u>                                                            | <u>\$ (1.30)</u>                                                                               |
| <b>Basic and diluted</b>                                   |                                                                             |                                                                             |                                                                                                |
| Weighted average shares outstanding - Basic<br>and diluted | <u>7,729,744</u>                                                            | <u>6,558,288</u>                                                            | <u>4,085,803</u>                                                                               |

\*Restated (see Note 3)

The accompanying notes are an integral part of these statements.

ZION OIL & GAS, INC.  
(A Development Stage Company)  
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

|                                                                                                    | <u>Preferred Stock</u> |               | <u>Common Stock</u> |               | <u>Additional</u>  | <u>Deficit</u>     |                    |
|----------------------------------------------------------------------------------------------------|------------------------|---------------|---------------------|---------------|--------------------|--------------------|--------------------|
|                                                                                                    | <u>Shares</u>          | <u>Amount</u> | <u>Shares</u>       | <u>Amount</u> | <u>Paid-in</u>     | <u>Accumulated</u> |                    |
|                                                                                                    |                        |               |                     |               | <u>Capital</u>     | <u>in</u>          | <u>Total</u>       |
|                                                                                                    |                        |               |                     |               | <u>As restated</u> | <u>Development</u> | <u>As restated</u> |
|                                                                                                    |                        |               |                     |               | *                  | Stage              | *                  |
|                                                                                                    |                        |               |                     |               |                    | <u>As restated</u> | *                  |
| Balances, April 6, 2000                                                                            | -                      | \$ -          | -                   | \$ -          | \$ -               | \$ -               | \$ -               |
| Issued for cash (\$0.001 per share)                                                                | -                      | -             | 2,400,000           | 240           | 2,160              | -                  | 2,400              |
| Issuance of shares and warrants in a private offering which closed in January 2001 (\$1 per share) | -                      | -             | 100,000             | 10            | 99,990             | -                  | 100,000            |
| Costs associated with the issuance of shares                                                       | -                      | -             | -                   | -             | (24,090)           | -                  | (24,090)           |
| Waived interest on conversion of debt                                                              | -                      | -             | -                   | -             | 233                | -                  | 233                |
| Value of warrants granted to employees                                                             | -                      | -             | -                   | -             | 1,840              | -                  | 1,840              |
| Net loss                                                                                           | <u>-</u>               | <u>-</u>      | <u>-</u>            | <u>-</u>      | <u>-</u>           | <u>(5,597)</u>     | <u>(5,597)</u>     |
| Balances, December 31, 2000                                                                        | -                      | -             | 2,500,000           | 250           | 80,133             | (5,597)            | 74,786             |
| Issuance of shares and warrants in a private offering which closed in January 2001 (\$1 per share) | -                      | -             | 135,000             | 13            | 134,987            | -                  | 135,000            |

|                                                                                                      |          |          |           |          |          |                  |                  |
|------------------------------------------------------------------------------------------------------|----------|----------|-----------|----------|----------|------------------|------------------|
| Issuance of shares and warrants in a private offering which closed in September 2001 (\$1 per share) | -        | -        | 125,000   | 12       | 124,988  | -                | 125,000          |
| Payment of accounts payable through issuance of shares and warrants                                  | -        | -        | 40,000    | 4        | 39,996   | -                | 40,000           |
| Payment of note payable through issuance of shares and warrants                                      | -        | -        | 25,000    | 3        | 24,997   | -                | 25,000           |
| Issuance of shares and warrants in a private offering which closed in November 2001 (\$1 per share)  | -        | -        | 175,000   | 18       | 174,982  | -                | 175,000          |
| Costs associated with the issuance of shares                                                         | -        | -        | -         | -        | (85,461) | -                | (85,461)         |
| Waived interest on conversion of debt                                                                | -        | -        | -         | -        | 843      | -                | 843              |
| Value of warrants granted to employees                                                               | -        | -        | -         | -        | 37,503   | -                | 37,503           |
| Value of warrants granted to directors and consultants                                               | -        | -        | -         | -        | 3,128    | -                | 3,128            |
| Net loss                                                                                             | <u>-</u> | <u>-</u> | <u>-</u>  | <u>-</u> | <u>-</u> | <u>(206,707)</u> | <u>(206,707)</u> |
| Balances, December 31, 2001                                                                          | -        | -        | 3,000,000 | 300      | 536,096  | (212,304)        | 324,092          |

(Continued on following page)

\* Restated (see Note 3)

The accompanying notes are an integral part of these statements.

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(Continued)

|                                                                                                      | <u>Preferred Stock</u> |               | <u>Common Stock</u> |               | <u>Additional</u><br><u>Paid-in</u><br><u>Capital</u><br><u>As restated</u><br><u>*</u> | <u>Deficit</u><br><u>Accumulated</u><br><u>in</u><br><u>Development</u><br><u>Stage</u><br><u>As restated *</u> | <u>Total</u><br><u>As restated</u><br><u>*</u> |
|------------------------------------------------------------------------------------------------------|------------------------|---------------|---------------------|---------------|-----------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|------------------------------------------------|
|                                                                                                      | <u>Shares</u>          | <u>Amount</u> | <u>Shares</u>       | <u>Amount</u> |                                                                                         |                                                                                                                 |                                                |
| Change in par value of common shares<br>from \$0.0001 per share to \$0.01 per share                  | -                      | -             | -                   | 29,700        | (29,700)                                                                                | -                                                                                                               | -                                              |
| Issuance of shares and warrants in a private offering which closed in January 2002 (\$1 per share)   | -                      | -             | 20,000              | 200           | 19,800                                                                                  | -                                                                                                               | 20,000                                         |
| Issuance of shares and warrants in a private offering which closed in November 2002 (\$10 per share) | 25,400                 | 254           | 21,500              | 215           | 253,531                                                                                 | -                                                                                                               | 254,000                                        |
| Payment of accounts payable through<br>issuance of preferred shares and warrants                     | 12,700                 | 127           | -                   | -             | 126,873                                                                                 | -                                                                                                               | 127,000                                        |
| Payment of accounts payable through<br>issuance of common shares and warrants                        | -                      | -             | 111,000             | 1,110         | 131,390                                                                                 | -                                                                                                               | 132,500                                        |
| Payment of note payable through<br>issuance of shares and warrants                                   | 5,000                  | 50            | -                   | -             | 49,950                                                                                  | -                                                                                                               | 50,000                                         |
| Payment of accounts payable to employee<br>through issuance of shares upon<br>exercise of warrants   | -                      | -             | 400,000             | 4,000         | 76,000                                                                                  | -                                                                                                               | 80,000                                         |
| Costs associated with the issuance of shares                                                         | -                      | -             | -                   | -             | (159,449)                                                                               | -                                                                                                               | (159,449)                                      |

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|                                                            |          |          |           |          |           |                  |                  |
|------------------------------------------------------------|----------|----------|-----------|----------|-----------|------------------|------------------|
| Waived interest on conversion of debt                      | -        | -        | -         | -        | 2,963     | -                | 2,963            |
| Deferred financing costs on debt conversions/modifications | -        | -        | -         | -        | 20,800    | -                | 20,800           |
| Value of warrants granted to employees                     | -        | -        | -         | -        | 537       | -                | 537              |
| Value of warrants granted to directors and consultants     | -        | -        | -         | -        | 12,998    | -                | 12,998           |
| Net loss                                                   | <u>-</u> | <u>-</u> | <u>-</u>  | <u>-</u> | <u>-</u>  | <u>(403,114)</u> | <u>(403,114)</u> |
| Balances, December 31, 2002                                | 43,100   | 431      | 3,552,500 | 35,525   | 1,041,789 | (615,418)        | 462,327          |

(Continued on following page)

\* Restated (see Note 3)

The accompanying notes are an integral part of these statements.

ZION OIL & GAS, INC.  
(A Development Stage Company)  
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(Continued)

|                                                                       | <u>Preferred Stock</u> |               | <u>Common Stock</u> |               | <u>Additional</u> | Deficit<br>Accumulated<br>in<br>Development<br>Stage | <u>Total</u>  |
|-----------------------------------------------------------------------|------------------------|---------------|---------------------|---------------|-------------------|------------------------------------------------------|---------------|
|                                                                       | <u>Shares</u>          | <u>Amount</u> | <u>Shares</u>       | <u>Amount</u> | <u>Capital</u>    |                                                      |               |
|                                                                       |                        |               |                     |               | As restated<br>*  | As restated *                                        | As restated * |
| Issuance of shares in connection with executive employment            | -                      | -             | 50,000              | 500           | 49,500            | -                                                    | 50,000        |
| Issuance of shares on warrants exercise                               | -                      | -             | 165,000             | 1,650         | 31,350            | -                                                    | 33,000        |
| Issuance of dividend shares to record holders as of December 31, 2002 | 4,310                  | 43            | -                   | -             | (43)              | -                                                    | -             |

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|                                                                                                      |          |       |         |       |          |   |          |
|------------------------------------------------------------------------------------------------------|----------|-------|---------|-------|----------|---|----------|
| Issuance of shares and warrants in a private offering which closed in February 2003 (\$10 per share) |          |       |         |       |          |   |          |
| for cash consideration                                                                               | 10,500   | 105   | -       | -     | 104,895  | - | 105,000  |
| for reduction of accounts payable                                                                    | 4,554    | 46    | -       | -     | 45,494   | - | 45,540   |
| Issuance of shares and warrants as compensation for extension of \$100,000 line of credit            |          |       |         |       |          |   |          |
|                                                                                                      | 1,000    | 10    | -       | -     | 9,990    | - | 10,000   |
| Payment of account payable through issuance of shares and warrants                                   |          |       |         |       |          |   |          |
|                                                                                                      | 100      | 1     | -       | -     | 999      | - | 1,000    |
| Conversion of preferred shares to common shares in reincorporation merger                            |          |       |         |       |          |   |          |
|                                                                                                      | (63,564) | (636) | 762,768 | 7,628 | (6,992)  | - | -        |
| Issuance of shares in a private offering which closed in July 2003 (\$3 per share)                   |          |       |         |       |          |   |          |
| for cash consideration                                                                               | -        | -     | 33,000  | 330   | 98,670   | - | 99,000   |
| for reduction of accounts payable                                                                    | -        | -     | 3,000   | 30    | 8,970    | - | 9,000    |
| Issuance of shares upon exercise of options and warrants:                                            |          |       |         |       |          |   |          |
| for cash consideration                                                                               | -        | -     | 25,000  | 250   | 24,750   | - | 25,000   |
| for reduction of accounts payable                                                                    | -        | -     | 124,083 | 1,241 | 142,217  | - | 143,458  |
| Issuance of shares upon exercise of warrants for cash consideration                                  |          |       |         |       |          |   |          |
|                                                                                                      | -        | -     | 63,500  | 635   | 82,115   | - | 82,750   |
| Payment of account payable through issuance of shares                                                |          |       |         |       |          |   |          |
|                                                                                                      | -        | -     | 80,000  | 800   | 139,200  | - | 140,000  |
| Costs associated with the issuance of shares                                                         |          |       |         |       |          |   |          |
|                                                                                                      | -        | -     | -       | -     | (58,484) | - | (58,484) |
| Value of warrants granted to employees                                                               |          |       |         |       |          |   |          |
|                                                                                                      | -        | -     | -       | -     | 47,008   | - | 47,008   |
| Deferred financing costs on debt conversions/modifications                                           |          |       |         |       |          |   |          |
|                                                                                                      | -        | -     | -       | -     | (9,812)  | - | (9,812)  |

|                             |       |       |           |        |           |             |           |
|-----------------------------|-------|-------|-----------|--------|-----------|-------------|-----------|
| Net loss                    | _____ | _____ | _____     | _____  | _____     | (873,310)   | (873,310) |
| Balances, December 31, 2003 | -     | -     | 4,858,851 | 48,589 | 1,751,616 | (1,488,728) | 311,477   |

(Continued on following page)

\* Restated (see Note 3)

The accompanying notes are an integral part of these statements.

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ZION OIL & GAS, INC.  
 (A Development Stage Company)  
 STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
 (Continued)

|                                                                                   | <u>Common Stock</u> |               | <u>Additional</u> | <u>Deficit</u>     |              |
|-----------------------------------------------------------------------------------|---------------------|---------------|-------------------|--------------------|--------------|
|                                                                                   | <u>Shares</u>       | <u>Amount</u> | <u>Paid-in</u>    | <u>Accumulated</u> |              |
|                                                                                   |                     |               | <u>Capital</u>    | <u>in</u>          | <u>Total</u> |
|                                                                                   |                     |               |                   | <u>Development</u> |              |
|                                                                                   |                     |               |                   | <u>Stage</u>       |              |
| Issuance of shares on warrants exercise                                           | 122,500             | 1,225         | 182,525           | -                  | 183,750      |
| Issuance of shares and warrants in a private offering                             | 251,250             | 2,512         | 1,002,488         | -                  | 1,005,000    |
| Payment of officer salaries through issuance of shares and warrants               | 46,250              | 463           | 184,537           | -                  | 185,000      |
| Payment of accounts payable to officers and consultants upon exercise of warrants | 80,186              | 802           | 98,644            | -                  | 99,446       |
| Payment of director honorariums through issuance of shares and warrants           | 11,250              | 112           | 44,888            | -                  | 45,000       |
| Payment of account payable through issuance of shares and warrants                | 12,500              | 125           | 49,875            | -                  | 50,000       |
| Payment of bridge loan through issuance of shares and warrants                    | 125,000             | 1,250         | 498,750           | -                  | 500,000      |
| Payment of bridge loan interest and commitment                                    | 7,500               | 75            | 29,925            | -                  | 30,000       |

fee through issuance of shares and warrants

Payment of bridge loan finders fee through

|                                 |       |    |       |   |       |
|---------------------------------|-------|----|-------|---|-------|
| issuance of shares and warrants | 2,500 | 25 | 7,475 | - | 7,500 |
|---------------------------------|-------|----|-------|---|-------|

Payment of service bonus through issuance

|                        |        |     |        |   |        |
|------------------------|--------|-----|--------|---|--------|
| of shares and warrants | 20,000 | 200 | 19,800 | - | 20,000 |
|------------------------|--------|-----|--------|---|--------|

Costs associated with the issuance of shares

|   |   |          |   |          |
|---|---|----------|---|----------|
| - | - | (59,000) | - | (59,000) |
|---|---|----------|---|----------|

Value of warrants granted to employees

|   |   |        |   |        |
|---|---|--------|---|--------|
| - | - | 40,625 | - | 40,625 |
|---|---|--------|---|--------|

Deferred financing costs on debt conversions/modifications

|   |   |        |   |        |
|---|---|--------|---|--------|
| - | - | 30,383 | - | 30,383 |
|---|---|--------|---|--------|

|          |          |          |          |                    |                    |
|----------|----------|----------|----------|--------------------|--------------------|
| Net loss | <u>-</u> | <u>-</u> | <u>-</u> | <u>(1,736,934)</u> | <u>(1,736,934)</u> |
|----------|----------|----------|----------|--------------------|--------------------|

|                             |           |        |           |             |         |
|-----------------------------|-----------|--------|-----------|-------------|---------|
| Balances, December 31, 2004 | 5,537,787 | 55,378 | 3,882,531 | (3,225,662) | 712,247 |
|-----------------------------|-----------|--------|-----------|-------------|---------|

(Continued on following page)

\*Restated (see Note 3)

The accompanying notes are an integral part of these statements.

ZION OIL & GAS, INC.  
(A Development Stage Company)  
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(Continued)

|                                           | <u>Common Stock</u> |               | <u>Additional</u>   | <u>Deficit</u>      |                     |
|-------------------------------------------|---------------------|---------------|---------------------|---------------------|---------------------|
|                                           | <u>Shares</u>       | <u>Amount</u> | <u>Paid-in</u>      | <u>Accumulated</u>  |                     |
|                                           |                     |               | <u>Capital</u>      | <u>in</u>           |                     |
|                                           |                     |               | <u>As restated*</u> | <u>Development</u>  |                     |
|                                           |                     |               |                     | <u>Stage</u>        |                     |
|                                           |                     |               |                     | <u>As restated*</u> | <u>Total</u>        |
|                                           |                     |               |                     |                     | <u>As restated*</u> |
| Issuance of shares on warrants exercised: |                     |               |                     |                     |                     |
| for cash                                  | 493,167             | 4,932         | 872,319             | -                   | 877,251             |
| for payment of deferred officer salaries  | 17,334              | 173           | 20,827              | -                   | 21,000              |
| for exchange of shares of common stock    | 120,000             | 1,200         | (1,200)             | -                   | -                   |

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|                                                                                  |           |          |            |                    |                    |
|----------------------------------------------------------------------------------|-----------|----------|------------|--------------------|--------------------|
| Issuance of shares and warrants in a private offering that closed in March 2005: |           |          |            |                    |                    |
| for cash                                                                         | 518,750   | 5,188    | 2,069,812  | -                  | 2,075,000          |
| for payment of deferred officer salaries                                         | 10,000    | 100      | 39,900     | -                  | 40,000             |
| for payment of accounts payable                                                  | 6,250     | 62       | 24,938     | -                  | 25,000             |
| Issuance of shares and warrants in a private offering that closed in June 2005:  |           |          |            |                    |                    |
| for cash                                                                         | 259,000   | 2,590    | 1,292,410  | -                  | 1,295,000          |
| for payment of directors honoraria                                               | 14,000    | 140      | 69,860     | -                  | 70,000             |
| for payment of accounts payable                                                  | 3,000     | 30       | 14,970     | -                  | 15,000             |
| Issuance of shares in a private offering that closed in October 2005:            |           |          |            |                    |                    |
| for cash                                                                         | 584,000   | 5,840    | 2,914,160  | -                  | 2,920,000          |
| for payment of deferred officer salaries                                         | 40,000    | 400      | 199,600    | -                  | 200,000            |
| for payment of accounts payable                                                  | 22,000    | 220      | 109,780    | -                  | 110,000            |
| Issuance of shares in a private offering that closed in December 2005            |           |          |            |                    |                    |
|                                                                                  | 80,000    | 800      | 439,200    | -                  | 440,000            |
| Shares to be issued for services provided by a director                          |           |          |            |                    |                    |
|                                                                                  | -         | -        | 41,666     | -                  | 41,666             |
| Value of warrants and options granted to employees                               |           |          |            |                    |                    |
|                                                                                  | -         | -        | 215,845    | -                  | 215,845            |
| Value of warrants granted to directors and consultants                           |           |          |            |                    |                    |
|                                                                                  | -         | -        | 16,500     | -                  | 16,500             |
| Deferred financing costs on debt conversions/modifications                       |           |          |            |                    |                    |
|                                                                                  | -         | -        | 43,968     | -                  | 43,968             |
| Costs associated with the issuance of shares                                     |           |          |            |                    |                    |
|                                                                                  | -         | -        | (275,098)  | -                  | (275,098)          |
| Net loss                                                                         | <u>-</u>  | <u>-</u> | <u>-</u>   | <u>(1,607,714)</u> | <u>(1,607,714)</u> |
| Balances, December 31, 2005                                                      | 7,705,288 | 77,053   | 11,991,988 | (4,830,376)        | 7,238,665          |

(Continued on following page)

\*Restated (see Note 3)

The accompanying notes are an integral part of these statements.

ZION OIL & GAS, INC.  
(A Development Stage Company)  
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(Continued)

|                                                                                  | <u>Common Stock</u> |                 | <u>Additional</u>   | <u>Deficit</u>       |                     |
|----------------------------------------------------------------------------------|---------------------|-----------------|---------------------|----------------------|---------------------|
|                                                                                  | <u>Shares</u>       | <u>Amount</u>   | <u>Paid-in</u>      | <u>Accumulated</u>   |                     |
|                                                                                  |                     |                 | <u>Capital</u>      | <u>in</u>            |                     |
|                                                                                  |                     |                 | <u>As restated*</u> | <u>Development</u>   |                     |
|                                                                                  |                     |                 |                     | <u>Stage</u>         | <u>Total</u>        |
|                                                                                  |                     |                 |                     | <u>As restated*</u>  | <u>As restated*</u> |
| Issuance of shares on warrants exercised:                                        |                     |                 |                     |                      |                     |
| for cash                                                                         | 3,500               | 35              | 17,465              | -                    | 17,500              |
| Issuance of shares and warrants in a private offering that closed in March 2006: |                     |                 |                     |                      |                     |
| for cash                                                                         | 66,000              | 660             | 362,340             | -                    | 363,000             |
| for payment of accounts payable                                                  | 2,500               | 25              | 13,725              | -                    | 13,750              |
| Shares to be issued for services provided by a director                          | -                   | -               | 62,499              | -                    | 62,499              |
| Value of options granted to employees                                            | -                   | -               | 46,674              | -                    | 46,674              |
| Costs associated with the issuance of shares                                     | -                   | -               | (12,180)            | -                    | (12,180)            |
| Net loss                                                                         | <u>-</u>            | <u>-</u>        | <u>-</u>            | <u>(486,473)</u>     | <u>(486,473)</u>    |
| Balances, March 31, 2006                                                         | <u>7,777,288</u>    | <u>\$77,773</u> | <u>\$12,482,511</u> | <u>(\$5,316,849)</u> | <u>\$7,243,435</u>  |

\*Restated (see Note 3)

The accompanying notes are an integral part of these statements.

ZION OIL & GAS, INC.  
(A Development Stage Company)  
Statements of Cash Flows (Unaudited)

Period from

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|                                                                                | Three-month<br>period ended<br><u>March 31, 2006</u> | Three-month<br>period ended<br><u>March 31, 2005</u> | April 6, 2000<br>(inception) to<br><u>March 31, 2006</u> |
|--------------------------------------------------------------------------------|------------------------------------------------------|------------------------------------------------------|----------------------------------------------------------|
| Cash flow from operating activities                                            |                                                      |                                                      |                                                          |
| Net Loss                                                                       | \$ (486,473)                                         | \$ (237,943)                                         | \$ (5,316,849)                                           |
| Adjustments to reconcile net loss to net<br>cash used in operating activities: |                                                      |                                                      |                                                          |
| Depreciation                                                                   | 3,110                                                | -                                                    | 8,953                                                    |
| Officer, director and other fees, paid via<br>common stock                     | 109,173                                              | 30,000                                               | 1,287,269                                                |
| Interest paid through issuance of<br>common stock                              | -                                                    | -                                                    | 17,500                                                   |
| Write-off of costs associated with<br>public offering                          | -                                                    | -                                                    | 507,380                                                  |
| Changes in assets and liabilities, net:                                        |                                                      |                                                      |                                                          |
| Increase in inventories                                                        | -                                                    | -                                                    | (149,801)                                                |
| Prepaid expenses and other                                                     | 4,271                                                | (27,786)                                             | (21,125)                                                 |
| Increase in deferred offering costs                                            | (79,485)                                             | -                                                    | (205,515)                                                |
| Refundable Value-Added tax                                                     | 17,932                                               | (121,559)                                            | (11,469)                                                 |
| Severance pay                                                                  | 2,134                                                | -                                                    | 43,908                                                   |
| Accounts payable                                                               | (480,696)                                            | 35,913                                               | 729,779                                                  |
| Accrued liabilities                                                            | 67,660                                               | 41,548                                               | 224,341                                                  |
| Increase in deferred officer's compensation                                    | <u>209,376</u>                                       | <u>-</u>                                             | <u>1,138,383</u>                                         |
| Net cash used in operating activities                                          | <u>(768,318)</u>                                     | <u>(279,827)</u>                                     | <u>(1,747,246)</u>                                       |
| Cash flows from investing activities                                           |                                                      |                                                      |                                                          |
| Acquisition of property and equipment                                          | (10,289)                                             | (151,680)                                            | (64,984)                                                 |
| Investment in oil and gas properties                                           | <u>(237,297)</u>                                     | <u>(607,802)</u>                                     | <u>(7,928,526)</u>                                       |
| Net cash used in investing activities                                          | <u>(247,586)</u>                                     | <u>(759,482)</u>                                     | <u>(7,993,510)</u>                                       |
| Cash flows from financing activities                                           |                                                      |                                                      |                                                          |
| Deferred financing cost on<br>debt conversions                                 | 8,440                                                | -                                                    | 78,123                                                   |
| Loan proceeds-related parties                                                  | -                                                    | -                                                    | 258,620                                                  |
| Loan principal repayments-related<br>party                                     | (500)                                                | (26,000)                                             | (109,660)                                                |
| Loan proceeds - other                                                          | -                                                    | -                                                    | 500,000                                                  |
| Proceeds from sale of stock                                                    | 380,500                                              | 2,478,886                                            | 10,289,651                                               |
| Financing costs of issuing<br>stock                                            | <u>(12,180)</u>                                      | <u>(52,195)</u>                                      | <u>(774,593)</u>                                         |
| Net cash provided by financing activities                                      | <u>376,260</u>                                       | <u>2,400,691</u>                                     | <u>10,242,141</u>                                        |

|                                 |                   |                     |                   |
|---------------------------------|-------------------|---------------------|-------------------|
| Net increase (decrease) in cash | (639,644)         | 1,361,382           | 501,385           |
| Cash - beginning of period      | <u>1,141,029</u>  | <u>468,409</u>      | <u>-</u>          |
| Cash - end of period            | <u>\$ 501,385</u> | <u>\$ 1,829,791</u> | <u>\$ 501,385</u> |

\*Restated (see Note 3)

(Continued on following page)

The accompanying notes are an integral part of these statements.

ZION OIL & GAS, INC.  
(A Development Stage Company)  
STATEMENTS OF CASH FLOWS (Unaudited) (Continued)

|                                                                            | Three-month<br>period ended | Three-month<br>period ended | Period from<br>April 6, 2000<br>(inception) to<br><u>March 31,</u><br><u>2006</u> |
|----------------------------------------------------------------------------|-----------------------------|-----------------------------|-----------------------------------------------------------------------------------|
|                                                                            | <u>March 31, 2006</u>       | <u>March 31, 2005</u>       | <u>As restated*</u>                                                               |
|                                                                            | <u>As restated*</u>         | <u>As restated*</u>         | <u>As restated*</u>                                                               |
| SUPPLEMENTAL INFORMATION                                                   |                             |                             |                                                                                   |
| Cash paid for interest                                                     | \$ 8,589                    | \$ 3,325                    | \$ 43,246                                                                         |
| Cash paid for income taxes                                                 | -                           | -                           | -                                                                                 |
| Shares to be issued for services provided by director                      | 62,499                      | -                           | 104,165                                                                           |
| Non-cash operating and financing activities:                               |                             |                             |                                                                                   |
| Payment of accounts payable through issuance of preferred and common stock | 13,750                      | 21,001                      | 950,248                                                                           |
| Payment of note payable through issuance of common stock                   | -                           | -                           | 575,000                                                                           |
| Payment of accounts payable through issuance of note payable               | -                           | -                           | 34,678                                                                            |
| Financing costs paid through issuance of common stock                      | -                           | -                           | 25,000                                                                            |
| Increase in accounts payable for financing costs                           | -                           | -                           | 381,549                                                                           |
| Waived interest on debt conversion                                         | -                           | -                           | 4,039                                                                             |
| Value of warrants and options granted to employees                         | 46,674                      | -                           | 390,032                                                                           |
| Value of warrants granted to directors                                     |                             |                             |                                                                                   |

|                                              |       |   |        |
|----------------------------------------------|-------|---|--------|
| and consultants                              | -     | - | 32,626 |
| Deferred financing costs on debt conversions | 8,440 | - | 74,084 |

\*Restated (see Note 3)

The accompanying notes are an integral part of these financial statements

ZION OIL & GAS, INC.

(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS (Unaudited)

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Nature of Operations

Effective July 9, 2003, Zion Oil & Gas, Inc., a Florida corporation ("Zion Florida") was merged into its wholly owned Delaware subsidiary, Zion Oil & Gas, Inc. (the Company), the purpose of which was solely to reincorporate from Florida to Delaware in anticipation of a public offering. Upon the reincorporation, all the outstanding shares of common stock in Zion Florida were converted into common stock of the Company on a one-to-one basis and all the outstanding shares of preferred stock in Zion Florida were converted into common stock of the Company at the ratio of twelve shares of common for each share of preferred stock. All of the outstanding warrants and options of Zion Florida were converted into equivalent warrants and options of the Company.

The Company holds a petroleum exploration license on approximately 98,100 acres of unproved properties in north-central Israel called the "Ma'anit-Joseph License", issued to the Company by the State of Israel. The term on the license expires April 30, 2007 and it contained a commitment to drill or reenter a well on or before April 30, 2005.

On April 10, 2005 the Company commenced the reentry of the Ma'anit #1 and deepening of the well. On July 19, 2005 the well reached a depth of 15,509 feet and testing and completion began thereafter. During drilling and completion operations, the well had numerous significant oil and gas shows in different zones. At present, completion operations on the Ma'anit #1 well have been temporarily suspended and the drilling rig has been released. On March 15, 2006 the terms of the license were amended to provide that the Company commence the drilling of a new well to a depth of at least 4,400 meters or reenter the Ma'anit #1 well on or before March 1, 2007. The Company's engineers are designing a comprehensive completion procedure using a smaller and less expensive completion rig for the purpose of reentering the Ma'anit #1 well.

Declaration of a commercial discovery on the Ma'anit-Joseph License prior to the end of the license term, as may in certain circumstances be extended, will entitle the Company to receive a 30-year lease (extendable on certain conditions for an additional 20 years) subject to compliance with a field development work program and production.

Effective August 1, 2005, the Company received formal notification and documentation from the Minister of National Infrastructures and the Petroleum Commissioner granting the Company's application for a Preliminary Permit with Priority Rights for an area covering approximately 121,100 acres abutting on and immediately to the north of the

Ma'anit-Joseph License. The permit is designated the "Asher" Permit and covers lands on Israel's coastal plain and Mt. Carmel range. The Asher Permit is for an 18-month period and is subject to a work program, with an estimated total cost as adjusted for the amended work program of \$265,000, which requires the Company to perform certain geological and geophysical work. Upon satisfactory performance in accordance with the work program, as may be amended, on May 16, 2006, the Company will have priority rights for the grant of an exploration license for a period of up to seven years for a portion of the Asher Permit area not to exceed 400,000 dunam (approximately 98,800 acres), subject to the fulfillment of the requirements of the Petroleum Law. Work on the program is in progress.

Operations in Israel are conducted through a branch office and the License and Permit are each held directly in the name of the Company. At present it is expected that all future income will be derived from Israeli operations.

#### Basis of Presentation

The unaudited interim financial statements have been prepared on a going concern basis, which contemplates realization of assets and liquidation of liabilities in the ordinary course of business. Since the Company is in the development stage, it has limited capital resources, no revenue, and a loss from operations. The appropriateness of using the going concern basis is dependent upon the Company's ability to obtain additional financing or equity capital to finance its current operations and, ultimately, to achieve profitable operations. The uncertainty of these conditions has created substantial doubt about the Company's ability to continue as a going concern. The unaudited interim financial statements do not include any adjustments that might result from the outcome of this uncertainty.

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### ZION OIL & GAS, INC.

(A Development Stage Company)

#### NOTES TO FINANCIAL STATEMENTS (Unaudited)

##### 1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION (CONTINUED)

#### Basis of Presentation (Continued)

The accompanying unaudited interim financial statements were prepared in accordance with generally accepted accounting principles for the preparation of interim financial statements and, therefore, do not include all disclosures necessary for a complete presentation of financial condition, results of operations, and cash flows in conformity with generally accepted accounting principles used in annual financial statements. All adjustments, which are, in the opinion of management, of a normal recurring nature and are necessary for a fair presentation of the interim financial statements, have been included. Nevertheless, these financial statements should be read in conjunction with the financial statements and related notes included in the Company's annual financial statements for the year ended December 31, 2005. The results of operations for the period ended March 31, 2006 are not necessarily indicative of the results that may be expected for the entire fiscal year or any other interim period.

#### Management Presentation and Liquidity

On February 17, 2004, the registration statement with the Securities and Exchange Commission was declared effective to offer 7,000,000 shares of the Company's common stock to the public. The minimum offering requirement of \$6,500,000 was not subscribed by the offering termination date of August 30, 2004. As a result, no securities were sold to the public, all escrow subscription funds (approximately \$3.7 million) that had been received relating to the offering were sent back to the subscribers by the escrow agent, and the Company removed from registration the 7,000,000 shares of the Company's common stock. Since then Management raised capital through debt and private

offerings and on January 25, 2006 filed a registration statement for a public offering with a lower minimum of \$2,450,000. In the opinion of management, all adjustments considered necessary for a fair presentation of financial position, results of operations, and changes in financial position have been included.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Financial Statements in United States Dollars

The currency of the primary economic environment in which the operations of the Company are conducted is the United States dollar ("dollar"). Therefore, the dollar has been determined to be the Company's functional currency. Non-dollar transactions and balances have been translated into dollars in accordance with the principles set forth in Statement of Financial Accounting Standards (SFAS) No. 52 "Foreign Currency Translation" (SFAS No. 52).

Transactions in foreign currency (primarily in New Israeli Shekels - "NIS") are recorded at the exchange rate as of the transaction date except for activities relating to balance sheet items which are recorded at the appropriate exchange rate of the corresponding balance sheet item. Monetary assets and liabilities denominated in foreign currency are translated on the basis of the representative rate of exchange at the balance sheet date. Non monetary assets and liabilities denominated in foreign currency are stated at historical exchange rates. All exchange gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statement of operations as they arise.

### Cash

The Company maintains its cash balance at two banks with one bank located in the United States and one bank located in Israel. For purposes of the statement of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

### Inventories

Inventories include equipment and materials to be used in future drilling and completion operations and are stated at the lower of cost or market value. Cost is determined by the weighted average method.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Oil and Gas Properties

The Company follows the full-cost method of accounting for oil and gas properties. Accordingly, all costs associated with acquisition, exploration and development of oil and gas reserves, including directly related overhead costs, are capitalized.

All capitalized costs of oil and gas properties, including the estimated future costs to develop proved reserves, are amortized on the unit-of-production method using estimates of proved reserves. Investments in unproved properties and major development projects are not amortized until proved reserves associated with the projects can be

determined or until impairment occurs. If the results of an assessment indicate that the properties are impaired, the amount of the impairment is included in income from continuing operations before income taxes and the adjusted carrying amount of the unproved properties is amortized on the unit-of-production method.

Abandonment of properties are accounted for as adjustments to capitalized costs with no loss recognized. During the quarter ended March 31, 2006 and the year ended December 31, 2005 no unproved property was found to be impaired. The net capitalized costs are subject to a "ceiling test" which limits such costs to the aggregate of the estimated present value of future net revenues from proved reserves discounted at ten percent based on current economic and operating conditions, plus the lower of cost or fair market value of unproved properties. The recoverability of amounts capitalized for oil and gas properties is dependent upon the identification of economically recoverable reserves, together with obtaining the necessary financing to exploit such reserves and the achievement of profitable operations.

The company has no economically recoverable reserves and no amortization base. Unproved oil and gas properties consist of capitalized exploration costs (all of which are excluded from the amortization base) of \$237,297 for the three month period ended March 31, 2006, \$6,296,291 for the year ended December 31, 2005, \$598,475 for the year ended December 31, 2004 and \$797,734 from inception (April 6, 2000) to December 31, 2003.

#### Property and Equipment

Property and equipment other than oil and gas property and equipment is recorded at cost and depreciated over their estimated useful lives of three to fourteen years.

#### Costs Associated With Public Offering

Costs associated with each specific private or public offering are accumulated until either the closing of the offering or its abandonment. If the offering is abandoned, the costs are expensed in the period the offering is abandoned. If the offering is completed and funds are raised, the accumulated costs are recorded as a reduction to the paid-in capital attributable to the offering. Financing costs not attributable to any specific offering are charged to expense as incurred.

#### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting year. Actual results could differ from those estimates.

#### Adoption of Recently Issued Accounting Standards

**SFAS 123R - Share Based Payments:** Prior to January 1, 2006, the Company applied the fair-value based method of accounting for all of its stock-based compensation plan in accordance with the provisions of Financial Accounting Standards Board's Statement No. 123, "Accounting for Stock-Based Compensation" (Statement 123")

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## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

#### Adoption of Recently Issued Accounting Standards (Continued)

**SFAS 123R-Share Based Payments (Continued):** The fair value of stock-based compensation granted to employees and directors prior to July 15, 2003, the date of the Company's first filing with the U.S. Securities and Exchange Commission, in connection with its IPO, was estimated on the date of grant using the minimum-value method as

permitted for private entities under Statement No. 123.

The fair value of stock-based compensation granted to employees and directors subsequent to July 15, 2003, is measured according to the Black Scholes option-pricing model and recognized over the requisite service period.

#### Non-employees

Non-employee grants have been recorded in accordance with the provisions of SFAS 123 and EITF 96-18. Compensation costs fully vested non-forfeitable equity instruments have been reflected at their fair value on the date of grant.

The fair value of options and warrants granted to non-employees prior to January 1, 2006, has been computed and accounted for in accordance with SFAS 123 and Emerging Issues Task Force (EITF) 96-18 *"Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services"*, and was measured according to the Black Scholes option-pricing model.

As of January 1, 2006, the Company adopted SFAS No. 123 (revised 2004) *"Share-Based Payments"* (SFAS 123R) using the modified prospective method, which requires measurement of compensation cost for all stock-based awards based upon the fair value on date of grant and recognition of compensation over the service period for awards expected to vest. Under this method, the Company will recognize compensation cost for awards granted beginning January 1, 2006, based on the Black Scholes option-pricing model. Furthermore, with the exception of stock options granted to employees prior to July 15, 2003, the date of the first filing with the U.S. Securities and Exchange Commission (SEC) in connection with the Initial Public Offering (IPO), the Company will recognize cost for unvested share-based awards as of January 1, 2006 based on the grant date fair value of those awards, adjusted for estimated forfeitures, if any, as previously calculated and reported for pro-forma disclosure purposes.

The value of stock options, as noted, is recognized as compensation expense on a straight-line basis, over the requisite service period of the entire award, net of estimated forfeitures. On adoption of the modified prospective method in adopting SFAS 123R, the Company did not need to adjust the corresponding 2005 amounts included in these financial statements.

The adoption of SFAS 123R has had no effect on the Company's balance sheet or results of operations.

SFAS 151 - Inventory Costs, an Amendment of Accounting Research Bulletin ("ARB") No. 43:

In November 2004, the FASB issued SFAS No. 151, *"Inventory Costs - an amendment of Accounting Research Bulletin No. 43, Chapter 4"* ("SFAS 151"). The amendments made by SFAS 151 clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current-period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005.

The adoption of this SFAS 151 has had no effect on the Company's balance sheet and results of operations.

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## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Adoption of Recently Issued Accounting Standards (Continued)

SFAS 153 - Exchanges of Nonmonetary Assets, an Amendment of Accounting Principles Bulletin (APB) Opinion No. 29, "Accounting for Nonmonetary Transaction":

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In December 2004, the FASB issued SFAS No. 153, *"Exchanges of Nonmonetary Assets - an amendment of Accounting Principles Bulletin (APB) Opinion No. 29, Accounting for Nonmonetary Transactions"* ("SFAS 153"). The guidance in APB Opinion No. 29 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in Opinion No. 29, however, included certain exceptions to that principle. SFAS 153 amends Opinion No. 29 to eliminate the exception for nonmonetary assets exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange.

The adoption of SFAS 153 has had no effect on the Company's financial position and results of operations.

### SFAS 154 - Accounting Changes and Errors Corrections:

In May 2005, the FASB issued SFAS No. 154, *"Accounting Changes and Errors Corrections"* ("SFAS 154"). SFAS 154 replaces APB Opinion No. 20, *"Accounting Changes"*, and FASB Statement No. 3, *"Reporting Accounting Changes in Interim Financial Statements"*, although it carries forward some of their provisions. SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. A change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets will be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS 154 is effective for changes in accounting principle made in fiscal years beginning after December 15, 2005.

The adoption of SFAS 154 has had no effect on the Company's balance sheet or results of operations.

### 3. RESTATEMENT OF PRIOR FINANCIAL STATEMENTS

The financial statements for the period ended March 31, 2006 and for the period from inception (April 6, 2000) until March 31, 2006 have been restated to reflect additional expenses related to stock warrants issued to employees and non-employees during the above mentioned periods and compensation cost with respect to equity awards provided with new debt issuances and/or debt modification.

The following tables present the impact of the financial statements adjustments on the Company's previously announced statements of operations for the year ended December 31, 2005 and/or the period from inception (April 6, 2000) until December 31, 2005 and on the balance sheet as of December 31, 2005 and the impact of the financial statements adjustments on the Company's previously announced unaudited statements of operations for the period ended March 31, 2006 and/or the period from inception (April 6, 2000) until March 31, 2006 and on the balance sheet as of March 31, 2006.

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## ZION OIL & GAS, INC.

(A Development Stage Company)

### NOTES TO FINANCIAL STATEMENTS

#### 3. RESTATEMENT OF PRIOR FINANCIAL STATEMENTS (CONTINUED)

##### Statement of Operations

| <u>Period ended March 31,</u> |             |             | <u>Inception (April 6, 2000)</u> |             |             |
|-------------------------------|-------------|-------------|----------------------------------|-------------|-------------|
| <u>2006</u>                   |             |             | <u>until March 31</u>            |             |             |
|                               |             |             | <u>2006</u>                      |             |             |
| As previously                 | Adjustments | As restated | As previously                    | Adjustments | As restated |

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|                                                         | reported           | (1)                | reported           | (1)                  |                     |                      |
|---------------------------------------------------------|--------------------|--------------------|--------------------|----------------------|---------------------|----------------------|
| Revenues                                                | \$ -               | \$ -               | \$ -               | \$ -                 | \$ -                | \$ -                 |
| General and administrative expenses                     |                    |                    |                    |                      |                     |                      |
| Legal and professional                                  | 142,101            | -                  | 142,101            | 2,078,729            | 58,167              | 2,136,896            |
| Salaries                                                | 187,162            | 46,674             | 233,836            | 1,351,759            | 344,095             | 1,695,854            |
| Other                                                   | <u>100,960</u>     | <u>-</u>           | <u>100,960</u>     | <u>809,107</u>       | <u>-</u>            | <u>809,107</u>       |
|                                                         | <u>430,223</u>     | <u>46,674</u>      | <u>476,897</u>     | <u>4,239,595</u>     | <u>402,262</u>      | <u>4,641,857</u>     |
| Loss from operations                                    | (430,223)          | (46,674)           | (476,897)          | (4,239,595)          | (402,262)           | (4,641,857)          |
| Other income (expense)                                  |                    |                    |                    |                      |                     |                      |
| )                                                       |                    |                    |                    |                      |                     |                      |
| Termination of initial public offering                  | -                  | -                  | -                  | (507,380)            | -                   | (507,380)            |
| Interest expense, net                                   | <u>(1,134)</u>     | <u>(8,440)</u>     | <u>(9,574)</u>     | <u>(89,487)</u>      | <u>(78,123)</u>     | <u>(167,610)</u>     |
| Loss before income taxes                                | (431,357)          | (55,114)           | (486,471)          | (4,836,462)          | (480,385)           | (5,316,847)          |
| Income tax                                              | <u>-</u>           | <u>-</u>           | <u>-</u>           | <u>-</u>             | <u>-</u>            | <u>-</u>             |
| Net loss                                                | <u>\$(431,357)</u> | <u>\$ (55,114)</u> | <u>\$(486,471)</u> | <u>\$(4,836,462)</u> | <u>\$ (480,385)</u> | <u>\$(5,316,847)</u> |
| Net loss per share of common stock - basic and diluted  | <u>\$ (0.06)</u>   | <u>\$ -</u>        | <u>\$ (0.06)</u>   | <u>\$ (1.18)</u>     | <u>\$ (0.12)</u>    | <u>\$ (1.30)</u>     |
| Weighted-average shares outstanding - basic and diluted | <u>7,729,744</u>   | <u>-</u>           | <u>7,729,744</u>   | <u>4,085,803</u>     | <u>-</u>            | <u>4,085,803</u>     |

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ZION OIL & GAS, INC.

(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

3. RESTATEMENT OF PRIOR FINANCIAL STATEMENTS (CONTINUED)

Balance sheet

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|                                                                                                         | As of March 31, 2006             |                    |                     |
|---------------------------------------------------------------------------------------------------------|----------------------------------|--------------------|---------------------|
|                                                                                                         | As previously<br><u>reported</u> | <u>Adjustments</u> | <u>As restated</u>  |
|                                                                                                         | (1)                              |                    |                     |
| Current assets                                                                                          |                                  |                    |                     |
| Cash and cash equivalents                                                                               | \$ 501,385                       | \$ -               | \$ 501,385          |
| Inventories                                                                                             | 149,801                          | -                  | 149,801             |
| Prepaid expenses and other                                                                              | 21,125                           | -                  | 21,125              |
| Deferred offering costs                                                                                 | 205,515                          | -                  | 205,515             |
| Deferred financing costs                                                                                | -                                | 11,255             | 11,255              |
| Refundable Value-Added Tax                                                                              | <u>11,469</u>                    | <u>-</u>           | <u>11,469</u>       |
| Total current assets                                                                                    | 889,295                          | 11,255             | 900,550             |
| Unproved oil and gas properties, full cost method                                                       | 7,928,526                        | 1,271              | 7,929,797           |
| Property and equipment                                                                                  |                                  |                    |                     |
| Net of accumulated depreciation                                                                         | 56,031                           | -                  | 56,031              |
| Other assets                                                                                            |                                  |                    |                     |
| Assets held for severance benefits                                                                      | <u>7,451</u>                     | <u>-</u>           | <u>7,451</u>        |
| Total other assets                                                                                      | <u>7,451</u>                     | <u>-</u>           | <u>7,451</u>        |
| Total assets                                                                                            | <u>\$ 8,881,303</u>              | <u>\$ 12,526</u>   | <u>\$ 8,893,829</u> |
| Liabilities and Stockholders' Equity                                                                    |                                  |                    |                     |
| Current liabilities                                                                                     |                                  |                    |                     |
| Notes payable to related parties                                                                        | \$ 81,000                        | \$ -               | \$ 81,000           |
| Accounts payable                                                                                        | 124,811                          | -                  | 124,811             |
| Accrued liabilities                                                                                     | <u>224,341</u>                   | <u>-</u>           | <u>224,341</u>      |
| Total current liabilities                                                                               | 430,152                          | -                  | 430,152             |
| Notes payable to related parties less current maturities                                                | 30,500                           | -                  | 30,500              |
| Provision for severance pay                                                                             | 51,359                           | -                  | 51,359              |
| Deferred officer compensation                                                                           | 1,138,383                        | -                  | 1,138,383           |
| Stockholders' equity                                                                                    |                                  |                    |                     |
| Common stock, par value \$.01; 20,000,000 shares<br>authorized; 7,777,288 shares issued and outstanding | 77,773                           | -                  | 77,773              |
| Additional paid-in capital                                                                              | 11,989,598                       | 492,913            | 12,482,511          |
| Deficit accumulated in development stage                                                                | <u>(4,836,462)</u>               | <u>(480,387)</u>   | <u>(5,316,849)</u>  |
| Total stockholders' equity                                                                              | <u>7,230,909</u>                 | <u>12,526</u>      | <u>7,243,435</u>    |

|                                            |                     |                  |                     |
|--------------------------------------------|---------------------|------------------|---------------------|
| Total liabilities and stockholders' equity | <u>\$ 8,881,303</u> | <u>\$ 12,526</u> | <u>\$ 8,893,829</u> |
|--------------------------------------------|---------------------|------------------|---------------------|

(1)

Adjustments reflect additional expense related to stock warrants issued to employees and non-employees and compensation costs with respect to equity awards provided with new debt issuances and/or debt modifications and reclassification. See also restated Notes 5 and 8.

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## ZION OIL & GAS, INC.

(A Development Stage Company)

### NOTES TO FINANCIAL STATEMENTS

#### 4. PROVISION FOR SEVERANCE PAY

Israeli law generally requires payment of severance pay upon dismissal of an employee or upon termination of employment in certain other circumstances. The following principal plans relate to the employees in Israel:

- The liability in respect of certain of the company's employees is discharged in part by participating in a defined contribution pension plan and making regular deposits with recognized pension funds. The deposits are based on certain components of the salaries of the said employees. The custody and management of the amounts so deposited are independent of the company's control and accordingly such amounts funded (included in expenses on an accrual basis) and related liabilities are not reflected in the balance sheet.
- Part of the liability is discharged by deposits made with severance pay funds.
- The liability for severance pay is calculated on the basis of the latest salary paid to each employee multiplied by the number of years of employment. The liability is covered by the amounts deposited including accumulated income thereon as well as by the unfunded provision.
- The expenses in respect of severance pay for the three month period ended March 31, 2006 and for the year ended December 31, 2005 and the period from April 6, 2000 to March 31, 2006 amounted to \$2,134, \$7,096, \$43,908 respectively.
- Withdrawals from the funds may be made only upon termination of employment.
- As of March 31, 2006 and December 31, 2005, the Company has a provision for severance pay of \$51,359 and \$48,318, respectively. As of March 31, 2006 and December 31, 2005 the Company has \$7,451 and \$6,544 respectively, deposited in funds managed by major Israeli banks which are earmarked to cover severance pay liability. Such deposits are not considered to be "plan assets" and are therefore included in other assets.

#### 5. UNPROVED OIL AND GAS PROPERTIES-FULL COST METHOD

Comprised as follows:

|                                                               | As of<br>March 31<br>2006<br>(Unaudited)<br>As restated* | As of<br>December 31<br>2005<br>(Unaudited)<br>As restated* |
|---------------------------------------------------------------|----------------------------------------------------------|-------------------------------------------------------------|
| Drilling operations, completion costs and other related costs | \$ 6,774,056                                             | \$ 6,642,101                                                |
| Capitalized salary costs                                      | 555,732                                                  | 512,109                                                     |
| Legal costs and license fees                                  | 341,312                                                  | 284,186                                                     |
| Other costs                                                   | <u>258,697</u>                                           | <u>254,104</u>                                              |
|                                                               | <u>\$ 7,929,797</u>                                      | <u>\$ 7,692,500</u>                                         |

\*Restated (see Note 3)

## 6. STOCKHOLDERS' EQUITY

The Company has reserved 671,825 shares of common stock as of March 31, 2006 for the exercise of warrants and options. These warrants and options have been excluded from earnings per share calculations because they are anti-dilutive for all periods presented. These warrants and options could potentially dilute basic earnings per share in future years. The warrants and options exercise prices and expiration dates are as follows:

## ZION OIL & GAS, INC.

(A Development Stage Company)

### NOTES TO FINANCIAL STATEMENTS (Unaudited)

## 6. STOCKHOLDERS' EQUITY (CONTINUED)

|                  | Exercise Price<br><u>Per Share (\$)</u> | Number<br><u>of Shares</u> | Expiration<br><u>_____Date</u> |
|------------------|-----------------------------------------|----------------------------|--------------------------------|
| To non-employees | 3.00                                    | 40,000                     | December 31, 2006              |

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|                            |      |                |                   |
|----------------------------|------|----------------|-------------------|
|                            | 5.00 | 10,000         | December 31, 2008 |
| To employees and directors |      |                |                   |
|                            | 4.00 | 75,000         | December 31, 2006 |
|                            | 5.00 | 85,000         | December 31, 2008 |
| To investors               |      |                |                   |
|                            | 5.00 | 442,200        | December 31, 2006 |
|                            | 5.50 | <u>19,625</u>  | December 31, 2008 |
|                            |      | <u>671,825</u> |                   |

The warrant transactions April 6, 2000 (inception) are shown in the table below:

|                                                                           | Number of<br>shares | Weighted<br>average<br>exercise<br>price |
|---------------------------------------------------------------------------|---------------------|------------------------------------------|
| Granted from April 6, 2000 (inception) to December 31, 2004 to:           |                     |                                          |
| Employees, officers and directors                                         | 1,460,936           | 1.10                                     |
| Others                                                                    | 816,667             | 2.06                                     |
| Expired/canceled                                                          | (300,000)           | 1.00                                     |
| Exercised                                                                 | <u>(1,000,269)</u>  | 0.67                                     |
| Outstanding, December 31, 2004                                            | 977,334             | 2.37                                     |
| Granted to:                                                               |                     |                                          |
| Employees, consultants, officers and directors as part of<br>compensation | 120,000             | 4.79                                     |
| Private placement investors                                               | 281,700             | 5.02                                     |
| Expired/canceled                                                          | (40,333)            | 1.39                                     |
| Exercised                                                                 | <u>(670,501)</u>    | 1.58                                     |
| Outstanding, December 31, 2005                                            | 668,200             | 4.78                                     |
| Issued                                                                    | 7,125               | 5.50                                     |
| Exercised                                                                 | <u>(3,500)</u>      | 5.00                                     |
| Outstanding, March 31, 2006                                               | <u>671,825</u>      | 4.78                                     |

Exercisable, March 31, 2006

671,825

4.78

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## ZION OIL &amp; GAS, INC.

(A Development Stage Company)

## NOTES TO FINANCIAL STATEMENTS (Unaudited)

## 6. STOCKHOLDERS' EQUITY (CONTINUED)

The following table summarizes information about stock warrants and options outstanding as of March 31, 2006:

| Range of<br>exercise<br>price (\$) | Number<br>outstanding | Shares underlying outstanding<br>warrants and options (all fully vested) |                                               |
|------------------------------------|-----------------------|--------------------------------------------------------------------------|-----------------------------------------------|
|                                    |                       | Weighted<br>average<br>remaining<br>contractual<br>life (years)          | Weighted<br>average<br>exercise<br>price (\$) |
| 3.00                               | 40,000                | 1.00                                                                     | 3.00                                          |
| 4.00                               | 75,000                | 1.00                                                                     | 4.00                                          |
| 5.00                               | 537,200               | 1.10                                                                     | 5.00                                          |
| 5.50                               | <u>19,625</u>         | 2.75                                                                     | 5.50                                          |
| 3.00 - 5.50                        | 671,825               |                                                                          | 4.78                                          |

Fair Value of Warrants and Options**Granted to employees**

The following table sets forth information about the weighted-average fair value of warrants granted to employees and directors during the periods indicated, using the Black Scholes option-pricing model and the weighted-average assumptions used for such grants:

|                                                                    | to March 31,<br><u>2006</u><br><u>As restated*</u> | to March 31,<br><u>2005</u><br><u>As restated*</u> | Period from April 6,<br>2000 (inception)<br>to March 31,<br><u>2006</u><br><u>As restated*</u> |
|--------------------------------------------------------------------|----------------------------------------------------|----------------------------------------------------|------------------------------------------------------------------------------------------------|
| Weighted-average fair value of underlying stock at grant date (\$) | 5.50                                               | -                                                  | 3.00 - 5.50                                                                                    |
| Dividend yields                                                    | -                                                  | -                                                  | -                                                                                              |
| Expected volatility                                                | 40.0%                                              | -                                                  | 28.2% - 40.0%                                                                                  |
| Risk-free interest rates                                           | 5.15%                                              | -                                                  | 2.1% - 5.15%                                                                                   |
| Expected lives                                                     | 4.76 years                                         | -                                                  | 1.74 - 5.00 years                                                                              |
| Average grant date fair market value--0.76                         |                                                    |                                                    |                                                                                                |

\*Restated (see Note 3)

## Granted to non-employees

The following table sets forth information about the weighted-average fair value of warrants granted to non-employees during the periods indicated, using the Black Scholes option-pricing model and the weighted-average assumptions used for such grants:

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### ZION OIL & GAS, INC.

(A Development Stage Company)

### NOTES TO FINANCIAL STATEMENTS

## 6. STOCKHOLDERS' EQUITY (CONTINUED)

### Fair Value of Warrants and Options (Continued)

|                                                                    | to March 31,<br><u>2006</u><br><u>As restated*</u> | to March 31,<br><u>2005</u><br><u>As restated*</u> | Period from April 6,<br>2000 (inception)<br>to March 31,<br><u>2006</u><br><u>As restated*</u> |
|--------------------------------------------------------------------|----------------------------------------------------|----------------------------------------------------|------------------------------------------------------------------------------------------------|
| Weighted-average fair value of underlying stock at grant date (\$) | -                                                  | -                                                  | 1.00 - 5.00                                                                                    |
| Dividend yields                                                    | -                                                  | -                                                  | -                                                                                              |
| Expected volatility                                                | -                                                  | -                                                  | 32.2% - 99.8%                                                                                  |
| Risk-free interest rates                                           | -                                                  | -                                                  | 2.8% - 4.42%                                                                                   |
| Contractual lives                                                  | -                                                  | -                                                  | 0.56 - 3.17 years                                                                              |
| Average grant date fair market value                               | -                                                  | -                                                  | 0.68                                                                                           |

\*Restated (see Note 3)

The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the options.

The expected life represents the weighted average period of time that options granted are expected to be outstanding. The expected life of the options granted to employees and directors during the first quarter of 2006 is calculated based on the Simplified Method as allowed under Staff Accounting Bulletin No. 107 (SAB 107), giving consideration to the contractual term of the options and their vesting schedules. The expected life of the option granted to non-employees equals their contractual term.

Due to the lack of sufficient history of the Company's own stock volatility, the Company estimates its own expected stock volatility based on the historic volatility for other oil exploration companies.

### Private Placement Offerings

During 2000, John Brown purchased 2,400,000 shares at the then current par value (\$0.001 per share) on his behalf and on behalf of 25 other founding shareholders. Between January 1, 2001 and December 31, 2004, the Company raised \$3,125,540 in private placements from the sale (adjusted for the reincorporation merger on July 9, 2003) of

1,830,298 shares of common stock and: (i) warrants with an original expiration date of December 31, 2004 to purchase 275,833 shares of common stock at \$1.00 per share; (ii) warrants with an original expiration date of December 31, 2004 to purchase 411,770 shares of common stock at \$1.50 per share; and (iii) warrants with an original expiration date of December 31, 2006 to purchase 181,500 shares of common stock at \$5.00 per share. The December 31, 2004 warrant expiration date was extended to January 31, 2005, by which date the warrants were converted.

Between January 1, 2005 and March 31, 2005, the Company raised \$2,140,000 through the sale of 535,000 shares of common stock and warrants to purchase 214,000 shares of the Company's common stock in a private placement offering. The warrants are exercisable at \$5.00 per share, expire December 31, 2006 and are designated "E Warrants." Between April 22 and June 10, 2005, the Company raised \$1,380,000 through the sale of 276,000 shares of common stock and 55,200 E warrants. Between June 20, 2005 and October 24, 2005, the Company raised \$3,230,000 through the sale of 646,000 shares of common stock.

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ZION OIL & GAS, INC.

(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS (Unaudited)

6. STOCKHOLDERS' EQUITY (CONTINUED)

Private Placement Offerings (Continued)

During December 2005 the Company raised \$390,000 from the exercise of warrants to purchase 130,000 shares of common stock. During December 2005, the Company raised \$440,000 from the sale of 80,000 shares of common stock and warrants to purchase 12,500 shares of common stock at \$5.50 per share at any time from July 1, 2007 (as may be deferred by the Company for up to six months) through December 31, 2008 such warrants being designated as "G warrants".

During the first quarter of 2006 the Company (i) raised \$374,000 from the sale of 68,000 shares of common stock and 7,125 G warrants; (ii) issued 500 shares of common stock for \$2,750 in services; and (iii) issued 3,500 shares of common stock for \$17,500 upon the exercise of E warrants.

Compensation Costs for Warrant and Option Issuances

The compensation cost of warrant and option issuances for the period ended March 31, 2006 and the year ended December 31, 2005 and for the period from April 6, 2000 (inception) to March 31, 2006 amounted to \$46,674, \$232,345 and \$442,762, respectively.

As of March 31, 2006, there was \$217,734 of unrecognized compensation cost, related to nonvested stock options granted under the Company's various stock option plans. That cost is expected to be recognized as follows:

2005 Stock Option Plan

During 2005, a stock option plan (the "Plan") was adopted by the Company, pursuant to which 1,000,000 shares of common stock are reserved for issuance to officers, directors, employees and consultants. The Plan will be administered by the Board of Directors or one or more committees appointed by the board (the "Administrator").

The Plan contemplates the issuance of stock options by the Company both as a private company and as a publicly traded company and will be available to residents of the United States, the State of Israel and other jurisdictions as

determined by the administrator. The award of stock options under the Plan will be made pursuant to an agreement between the Company and each grantee. The agreement will, among other provisions, specify the number of shares subject to the option, intended tax qualifications, the exercise price, any vesting provisions and the term of the stock option grant, all of which shall be determined on behalf of the Company by the Administrator. The Plan will remain in effect for a term of ten years unless terminated or extended according to its provisions. As of the date of authorization of these financial statements no awards have been made under the Plan. See Note 10.

ZION OIL & GAS, INC.

(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS (Unaudited)

7. RELATED PARTY TRANSACTIONS

Cimarron Resources, Inc.

Notes payable to related parties includes \$36,500 under a loan facility with Cimarron Resources, Inc. (Cimarron) a company owned by the CEO of the Company. Cimarron obtained the monies to lend to the Company through a loan facility with Bank One. The note accrues interest at Bank One's Prime Rate plus 2.5%. The terms of Cimarron's loan facility to Zion are a 100 month term loan repayable monthly commencing December 1, 2003 in \$500 increments, with Cimarron having the option commencing January 15, 2005 to call the loan in whole or in \$5,000 increments on 30 days notice which call option has subsequently been deferred until July 31, 2007.

Rappaport Loan

Notes payable to related parties includes a \$75,000 note payable under a line of credit loan agreement with a shareholder of the Company. Any outstanding balance may be converted at the election of the lender to shares of common stock in increments of \$5,000 at \$4.00 per share. Outstanding balances will accrue interest at 10% per annum. At the direction of the shareholder, a commitment fee of \$10,000 was paid to two children of the shareholder in the form of 12,000 shares of common stock and warrants to purchase 5,000 shares of the Company's common stock.

Robert E. Render

During the three months ended March 31, 2006, Mr. Render provided \$7,500 of consulting services to the Company.

Richard J. Rinberg

In connection with arranging the "\$300,000 loans", Mr. Richard J. Rinberg, prior to becoming a director, received a \$7,500 fee paid in 2,500 shares of common stock.

During October 2005 Mr. Richard J. Rinberg was elected President of the Company and the board of directors approved an award to Mr. Rinberg of 200,000 shares of common stock valued at \$500,000 as compensation for the two year period beginning November 1, 2005, subject to restrictions and vesting requirements. The company received a valuation from a firm of external valuers supporting this valuation. The Rinberg shares are subject to repurchase by the Company at \$0.01 per share if Mr. Rinberg leaves his position with the Company, such repurchase rights being pro-rated over the 24-month period beginning November 1, 2005. The shares were issued in May 2006. See Note 10.

## 8. INCOME TAXES

As at March 31, 2006, the Company has available net operating loss carry-forwards of approximately \$4,122,000 to reduce future U.S. taxable income. These carry-forwards expire from 2020 to 2025.

As at March 31, 2006, the Company has available net operating loss carry-forwards of approximately \$8,278,892 to reduce future Israeli taxable income.

## 9. COMMITMENTS AND CONTINGENCIES

### Environmental Matters

The Company is engaged in oil and gas exploration and production and may become subject to certain liabilities as they relate to environmental cleanup of well sites or other environmental restoration procedures as they relate to the drilling of oil and gas wells in the operation thereof. Although environmental assessments are conducted on all purchased properties, in the Company's acquisition of existing or previously drilled well bores, the Company may not be aware of what environmental safeguards were taken at the time such wells were drilled or during such time the wells were operated.

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ZION OIL & GAS, INC.

(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS (Unaudited)

## 9. COMMITMENTS AND CONTINGENCIES (CONTINUED)

### Environmental Matters (Continued)

Should it be determined that a liability exists with respect to any environmental clean up or restoration, the liability to cure such a violation could fall upon the Company. No claim has been made, nor is the Company aware of any contingent demands relating thereto. Liabilities for expenditures are recorded when environmental assessment and/or remediation is probable and the costs can be reasonably estimated.

### Royalty Commitments

The Company is obligated, according to the Israeli Petroleum Law, 5712-1952 (the "Petroleum Law"), to pay royalties to the Government of Israel on the gross production of oil and gas from the oil and gas properties of the Company located in Israel (except those reserves serving to operate the wells and related equipment and facilities). The royalty rate stated in the Petroleum Law is 12.5% of the produced reserves. At March 31, 2006, the Company did not have any outstanding obligation in respect to royalty payments, since it is at the "exploration stage" and, to this date, no proved reserves have been found.

### Long Term Incentive Plan

The Company has initiated the establishment of a long-term management incentive plan for key employees whereby a 1.5% overriding royalty or equivalent interest in the Ma'anit-Joseph license and such other oil and gas exploration and development rights as may in the future be acquired by the Company shall be assigned to key employees.

## Charitable Trusts

The Company has initiated the establishment of two charitable trusts based in Israel and in the United States for the purpose of supporting charitable projects and other charities in Israel and the United States. A 3% overriding royalty or equivalent interest in the Ma'anit-Joseph License and such other oil and gas exploration and development rights as may in the future be acquired by the Company shall be assigned to each charitable organization (6% overriding interest in the aggregate).

## 10. SUBSEQUENT EVENTS

Following the balance sheet date, the Company (i) raised \$99,000 from the sale of 18,000 shares of common stock; (ii) issued 6,000 shares of common stock for \$30,000 upon the exercise of E warrants; (iii) issued 200,000 shares of common stock to a trust company for the benefit of Richard Rinberg; (iv) borrowed \$62,500 on one-year notes from five shareholders; (v) issued 30,000 shares of common stock for \$90,000 upon exercise of C warrants; and (vi) on July 5, 2006, options were awarded under the 2005 Stock Option Plan as follows: (a) to two directors for the purchase of 50,000 shares of common stock at \$5.00 per share through December 31, 2008 at a value of \$58,647; (b) to one employee for the purchase of 80,000 shares of common stock at \$5.00 per share through December 31, 2010 - these options will vest in three equal tranches of 26,667 shares each on January 1, 2007, on January 1, 2008 and on January 1, 2009 at a value of \$193,600 that will be charged according to the vesting periods, and the options may not be exercised prior to July 1, 2007 (subject to deferral by the Company for a period of up to six months); and (c) to one employee for the purchase of 40,000 shares of common stock at \$5.00 per share through December 31, 2010 - these options will vest in four equal tranches of four vesting periods of 10,000 shares each, on the grant date, on October 1, 2006, on October 1, 2007 and on October 1, 2008 at a value of \$96,800 that will be charged according to the vesting periods, the options may not be exercised prior to July 1, 2007 (subject to deferral by the Company for a period of up to six months).

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### Introduction

The following discussion and analysis should be read in conjunction with our accompanying financial statements and the notes to those financial statements included elsewhere in this Quarterly Report. The following discussion includes forward-looking statements that reflect our plans, estimates and beliefs and involve risks and uncertainties. Our actual results could differ materially from those discussed in these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below and elsewhere in this Quarterly Report.

### Overview

We are engaged in oil and natural gas exploration upon 219,000 acres of preliminary permit and exploration license areas in the State of Israel. During the six years between our formation and March 31, 2006, we have issued equity securities in the amount of \$12,560,284 and have incurred an accumulated liability of \$1,650,394 in order to operate our company and satisfy our work commitments under our agreements with the State of Israel. All of our officers and

key employees have deferred the majority of their salaries and other compensation during this period. They have all exchanged portions of the deferred compensation from time to time for our equity securities, which (with four exceptions relating to employment stock options) have all been priced at the same price as the sales of our private equity capital.

On January 25, 2006, we filed a Registration Statement with the Securities and Exchange Commission on Form SB-2 and have since filed five amendments to that Statement for the registration of 2,672,000 shares of our common stock. This Registration Statement has not yet been declared effective by the Commission.

Neither our common stock nor our warrants are listed or traded on any stock exchange or organized market, and there is therefore no market for them.

#### Going Concern Basis

Our unaudited interim financial statements for the period ended March 31, 2006 have been prepared on a going concern basis, which contemplates realization of assets and liquidation of liabilities in the ordinary course of business. Since Zion is in the development stage, we have limited capital resources, insignificant revenue, and a loss from operations. The appropriateness of using the going concern basis is dependent upon our ability to obtain additional financing or equity capital and, ultimately, to achieve profitable operations. The uncertainty of these conditions raises substantial doubt about our ability to continue as a going concern. The unaudited financial statements do not include any adjustments that might result from the outcome of this uncertainty. Uncertainties about our ability to continue as a going concern would be significantly reduced upon the closing of the initial public offering, if successful.

#### Restatement of Prior Period Financial Statements

The financial statements for the period ended March 31, 2006 and for the period from inception (April 6, 2000) until March 31, 2006 have been restated to reflect additional expenses related to stock warrants issued to employees and non-employees during the above mentioned periods and compensation cost with respect to equity awards provided with new debt issuances and/or debt modification.

#### Liquidity and Capital Resources

Working capital (current assets minus current liabilities) was \$470,398 and \$499,094 at March 31, 2006 and December 31, 2005, respectively.

Net cash provided by financing activities was \$376,260 and \$2,400,691 for the three months ended March 31, 2006 and 2005, respectively, of which \$368,320 in 2006 and \$2,426,691 in 2005 was from the sale of equity securities, net of equity sales costs. The remainder was provided by loans (less repayments of loans). Net cash used in investing activities was \$247,586 and \$759,482 for the three months ended March 31, 2006 and 2005, respectively, virtually all of which was used for capitalized exploration costs on the license.

On March 31, 2006, we had cash and cash equivalents in the amount of \$500,000 and accounts payable within the next 90 days of approximately \$125,000 for a net of approximately \$375,000. If we are not successful in completing the minimum offering, we will not have sufficient liquidity to meet our cash requirements for the next year and may be forced to seek buyers for portions of our petroleum interests. If the minimum amount is raised in the offering described above and we are able to raise an additional approximate amount of \$1,250,000 from additional sources (including the exercise of warrants expiring December 31, 2006), we should have sufficient funds to satisfy our cash requirements through June 2007.

## Results of Operations

We have no revenue generating operations as we are still an exploration stage company; however, drilling operations on the Ma'anit #1 commenced on April 10, 2005 and the rig was released seven months later. Almost all of our net loss for the three months ended March 31, 2006, comes from general and administrative expenses. Such expenses totaled \$476,897, consisting of \$142,101 for legal and professional costs, \$233,836 for salaries, most of which is deferred compensation (a non-cash expense) of our directors, officers and key employees, and other costs in the amount of \$100,960.

### ITEM 3. CONTROLS AND PROCEDURES

We maintain controls and procedures designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those controls and procedures as of the end of the period covered by this Quarterly Report, our Chief Executive Officer and our principal financial officer concluded that our disclosure controls and procedures were adequate.

We made no changes in our internal controls over financial reporting that occurred subsequent to the date of the evaluation of those controls by our Chief Executive Officer and principal financial officer that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II--OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS.

None.

### ITEM 2. CHANGES IN SECURITIES

Recent Sales of Unregistered Securities (as of March 31, 2006)

#### 1. Exercise of Outstanding Warrants.

During the three months ended March 31, 2006, two of our shareholders exercised their rights under currently outstanding warrants to purchase 3,500 shares of common stock for cash consideration of \$17,500. The sales of these securities were made in reliance upon Section 4(2) of the Securities Act, which provides exemptions for transactions not involving a public offering. All purchasers were existing stockholders of Zion and the shares purchased were purchased by way of warrants held by the stockholders that were acquired in the connection with their prior purchase or purchases of common stock. The certificates evidencing the securities purchased bear legends stating that the shares are not to be offered, sold or transferred other than pursuant to an effective registration statement under the Securities Act or an exemption from such registration requirements.

2.

Issuance of Common Stock and Warrant to U.S. Residents. On January 14, 2006, we sold 48,000 shares of our common stock and "G Warrants" to purchase 3,125 shares of common stock to nine investors for a total consideration of \$264,000. Of the total consideration, \$253,000 was paid in cash by eight investors and \$11,000 was paid by a cancellation of outstanding indebtedness owed by us to one of the investors. The G Warrants are exercisable at \$5.50 per share commencing July 1, 2007 (as may be extended for up to six months by Zion) through December 31, 2008. None of the G Warrants has been exercised. The sales of these securities were made in reliance upon Section 4(2) of

the Securities Act, which provides exemptions for transactions not involving a public offering. We determined that the purchasers of securities described above were sophisticated investors who had the financial ability to assume the risk of their total investment, acquired them for their own account and not with a view to any distribution thereof to the public. The certificates evidencing all the securities above bear legends stating that the shares are not to be offered, sold or transferred other than pursuant to an effective registration statement under the Securities Act or an exemption from such registration requirements.

3.

Issuance of Common Stock and Warrants to Non-U.S. Residents. On January 14, 2006, we sold 20,000 shares of our common stock and G Warrants to purchase 4,000 shares of common stock to one investor for a total consideration of \$110,000 in cash. The G Warrants are exercisable at \$5.50 per share commencing July 1, 2007 (as may be extended forp to six months by Zion) through December 31, 2008. None of the G Warrants has been exercised. The sales of these securities were made in reliance upon Regulation S promulgated pursuant to the Securities Act, which provides an exemption for offers deemed to occur outside of the United States. The investor was a non-U.S. resident. We determined that the purchaser of securities described above was a sophisticated investor who had the financial ability to assume the risk of his total investment, acquired them for his own account and not with a view to any distribution thereof to the public. The certificates evidencing all the securities above bear legends stating that the shares are not to be offered, sold or transferred

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other than pursuant to Regulation S, an effective registration statement under the Securities Act, or an exemption from such registration requirements.

#### 4. Stock for Services.

On January 14, 2006, we issued 500 shares of common stock valued at \$2,750 to our Israeli controller for accounting services rendered. The sales of these securities was made in reliance upon Regulation S promulgated pursuant to the Securities Act, which provides an exemption for offers deemed to occur outside of the United States. We determined that the purchaser of securities described above was a sophisticated non-U.S. resident who had the financial ability to assume the risk of his total investment, acquired them for his own account and not with a view to any distribution thereof to the public. The certificates evidencing all the securities above bear legends stating that the shares are not to be offered, sold or transferred other than pursuant to Regulation S, an effective registration statement under the Securities Act, or an exemption from such registration requirements.

#### ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

#### ITEM 4.

##### SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None

#### ITEM 5. OTHER INFORMATION.

Registration Statement for an Initial Public Offering

On January 26, 2006, Zion filed a registration statement on Form SB-2 with the Securities and Exchange Commission ("SEC") for the offering and sale on a best efforts basis through Network 1 Financial Securities, Inc. ("Network 1") and other brokers dealers with which Network 1 (collectively, the "Network Group") of up to 2,000,000 shares of

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Zion's common stock ("Shares") for \$7.00 per share. The registration statement has been subsequently amended five times and provides that, unless a minimum of 350,000 Shares are sold within 90 days of the effective date of the offering (which period may be extended subject to certain conditions for additional periods of up to 120 days), the offering will terminate. The Registration Statement includes 150,000 Shares to be gifted by executive officers of Zion and up to 521,200 Shares underlying certain outstanding warrants previously issued by Zion.

### ITEM 6. EXHIBITS

#### Exhibit Index

- |      |                                                                                                              |
|------|--------------------------------------------------------------------------------------------------------------|
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) under the Exchange Act         |
| 31.2 | Certification of the Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) under the Exchange Act |
| 32.1 | Section 1350 Certification of Chief Executive Officer                                                        |
| 32.2 | Section 1350 Certification of Principal Financial Officer                                                    |

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### SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized. In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

ZION OIL & GAS, INC.

(Registrant)

By: /s/ Eugene A. Soltero  
Eugene A. Soltero

By: /s/David Patir  
David Patir, Senior Vice-President

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Chief Executive Officer  
(Principal Executive Officer)

(Principal Financial and  
Accounting Officer)

Date: September \_\_, 2006

Date: September \_\_, 2006