

ZION OIL & GAS INC
Form 10KSB
April 15, 2005

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-KSB
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2004
COMMISSION FILE NUMBER 333-107042

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)

(Zip Code)

(214) 221-4610

(Issuer's Telephone Number, Including Area Code)

Securities registered under Section 12 (b) of the Exchange Act: None

Securities registered under Section 12 (g) of the Exchange Act:

| |
|--|
| Common Stock, par value \$0.01 per share |
|--|

[none]

(Title of Class)

(Name of each exchange on which registered)

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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 **X**

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of the Issuer's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. **[X]**

The Issuer's revenues for the fiscal year ended December 31, 2004 were \$0. The Issuer had 6,568,288 shares of common stock outstanding as of April 14, 2005. The aggregate market value of the voting and non-voting common stock held by non-affiliates of the Issuer, computed by reference to the average bid and asked prices of such common stock as of April 14, 2005, was \$0, as no public market currently exists.

DOCUMENTS INCORPORATED BY REFERENCE

The following document is incorporated by reference into Items 1 and 2 of Part I and Items 9, 10, and 12 of Part III: Prospectus dated February 17, 2004 for the sale of a maximum of 7,000,000 shares of common stock incorporated as Part I of Amendment #4 to Form SB-2 Registration Statement filed with the SEC on February 12, 2004 (the "Registration Statement"), pursuant to Regulation ST (insofar as it supercedes Rule 424(b)) of the Securities Act of 1933, as amended (the "Securities Act"), and hereinafter referred to as the "Prospectus."

The following document is incorporated by reference into Item 1 of Part I and Items 9, 10 and 12 of Part III: Form 8-K filed on November 19, 2004.

The following document is incorporated by reference into Item 1 of Part I and Item 9 of Part III: Form 8-K filed on January 5, 2005.

Transitional Small Business Disclosure Format (Check one): Yes___ No X

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2004 ANNUAL REPORT (S.E.C. FORM 10-KSB)

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Securities and Exchange Commission
Item Number and Description

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FORWARD LOOKING STATEMENTS

All statements, other than statements of historical fact included in this Annual Report on Form 10-KSB (herein, "Annual Report") regarding our strategy, future operations, financial position, estimated revenues and losses, projected costs, prospects, plans and objectives of management are forward-looking statements. When used in this Annual Report, the words "may", "should", "could," "believe," "anticipate," "intend," "estimate," "expect," "project" and similar expressions (or the negatives thereof) are intended to identify forward-looking statements, although not all

forward-looking statements contain such identifying words. All forward-looking statements speak only as of the date of this Annual Report. You should not place undue reliance on these forward-looking statements. Although we believe that our plans, intentions and expectations reflected in or suggested by the forward-looking statements we make in this Annual Report are reasonable, we can give no assurance that these plans, intentions or expectations will be achieved. We disclose important factors that could cause our actual results to differ materially from our expectations under "Risk Factors," in the Prospectus, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this Annual Report. These cautionary statements qualify all forward-looking statements attributable to us or persons acting on our behalf.

Unless the context otherwise requires, references in this Annual Report to "Zion," "we," "us," "our" or "ours" refer to Zion Oil & Gas, Inc.

References to the "Prospectus" refer to the Prospectus of Zion as defined at "Documents Incorporated by Reference" on the cover page of this Annual Report.

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PART I

ITEM 1. DESCRIPTION OF BUSINESS

Incorporated by reference to the following sections of the Prospectus:

"BUSINESS AND PROPERTIES:"--

"Background:" - Unchanged

"Israel's Petroleum Law" - Unchanged except for the following: The Petroleum Rights Fees as stated in New Israeli Shekels described are

also effective on January 1, 2005 and the US Dollar values therein stated should be recalculated at the Representative Rate of US \$1.00

equals NIS 4.395 as published by the Bank of Israel on April 15, 2005

"Proposed Changes in the Petroleum Law" - Unchanged, except that the bill submitted in conjunction with the 2003 budget proposal and

rejected in committee at that time hasn't been resubmitted since.

"Petroleum Taxation" - Unchanged except for the following: The Corporate Tax rate on taxable income from Israeli sources was a flat

rate of 35% in 2004, with a scheduled reduction to 34% in 2005.

"Proposed Changes in Petroleum Taxation" - Unchanged except for the following: The Petroleum Rights Fees as stated in New Israeli

Shekels described are also effective on January 1, 2005 and the US Dollar values therein stated should be recalculated at the

Representative Rate of US \$1.00 equals NIS 4.395 as published by the Bank of Israel on April 15, 2005

"Employees" - Unchanged except for the following: The sentence and chart outlining anticipated staffing based on the now

terminated offering should be deleted. In Dallas, Texas, USA we currently have five (5) employees (two (2) of whom are temporarily

assigned to the Israeli Branch) and one (1) consultant on a full time basis (temporarily assigned to the Israeli Branch) and three

(3) consultants on a part time basis. In Los Angeles, California, USA we currently have two (2)

employees on a part time basis. In Tel Aviv, Israel we have one (1) employee on a full time basis,

one (1) on a part time basis and four (4) consultants on a part time basis.

"Summary of Material Corporate Events" - Unchanged except for the addition of the following:

As a result of our failure to raise the specified minimum amount of investment, we abandoned

our initial public offering as of August 30, 2004. We commenced a private placement of Company

securities on September 30, 2004 and terminated it on March 31, 2005.

Incorporated by reference to Section 5 "Corporate Governance and Management" of the Form 8K filed

on November 19, 2004.

Incorporated by reference to Form 8K filed on January 5, 2005, in connection with the resignation of Ralph

F. DeVore as a Director of the Company.

"PLAN OF OPERATION AND MANAGEMENT'S DISCUSSION" -

"Markets" - Unchanged, except that the price per million BTU for which we believe we will be able to sell our natural gas is estimated to be \$2.85

"Charitable Trusts" - Unchanged

ITEM 2. DESCRIPTION OF PROPERTY

Incorporated by reference to the following section of the Prospectus:

"BUSINESS AND PROPERTIES" -

"Properties" - Unchanged except for the following: We reached an agreement with the Kibbutz Ma'anit

with respect to the rental through August 31, 2005 (the period estimated as necessary for the drilling and testing of the Ma'anit #1 well) of surface rights to the drill site. The rent has been paid in full. A drilling

contract was negotiated and signed between the Company and Lapidoth Israel Oil Prospectors Corp. on

December 29, 2004, rig-up began on or about March 20, 2005 and the re-entry and deepening of the Ma'anit

#1 was commenced on April 10, 2005. With the commencement of the drilling operations on the Ma'anit #1,

the Commissioner of Petroleum Affairs extended the Ma'anit -Joseph License through April 30, 2007,

subject to the submission of a satisfactory plan for a continuation of exploration in the License area within

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four (4) months after completion of the drilling and testing of the Ma'anit #1 well. Formal permits for the use of the drilling location and drilling operations from the Israel Lands Authority and the Haifa Regional Planning Commission have not yet been issued, although all necessary documentation has been submitted and oral confirmations received from the relevant authorities to the effect that the required permits will be issued.

"Israel's Petroleum Law" - Unchanged except for the following: The Petroleum Rights Fees as stated in New Israeli Shekels described

are also effective on January 1, 2005.

"Requirements and entitlements of holders of petroleum rights" - Unchanged

ITEM 3. LEGAL PROCEEDINGS

We are not party to any legal proceedings.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted to a vote of security holders, through solicitation of proxies or otherwise, during the period from October 1, 2004, through December 31, 2004.

PART II

ITEM 5. MARKET FOR THE COMPANY'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

Market for the Common Stock

We commenced our initial public offering on February 17, 2004 and when the minimum amount (\$6,500,000) was not subscribed by August 30, 2004, we terminated the offering as of that date. All investor funds had been held in a third-party escrow account and were subsequently returned to the investors with interest. Our common stock and warrants are not listed or traded on any stock exchange or organized market, and there is therefore no market for them.

Holders

As of April 14, 2005, there were 338 record holders of our common stock.

Dividends

We have never paid dividends on our common stock and do not plan to pay dividends on the common stock in the foreseeable future. Whether dividends will be paid in the future will be in the discretion of our board of directors and will depend on various factors, including our earnings and financial condition and other factors our board of directors considers relevant. We currently intend to retain earnings to develop and expand our business.

Recent Sales of Unregistered Securities (as of March 31, 2005)

As of March 31, 2005, the Company completed a private placement commenced on September 30, 2004 in which 988,750 shares of our common stock and "E" Warrants to purchase 395,500 shares of common stock were sold to ninety-four (94) investors for a total consideration of \$3,955,000. Of the total consideration, \$3,094,001 was paid in cash by eighty-four (84) investors, thirty-eight (38) of whom were "accredited" investors in the amount of \$1,455,000, thirty-five (35) were "non-accredited" investors in the amount of \$1,237,000, and eleven (11) were not residents of the United States in the amount of \$402,001. The remaining consideration of \$860,999 was paid by cancellation or reduction of outstanding indebtedness owed by us to thirteen (13) investors (of which three were also cash investors and all of which are either "accredited" or non-US residents), ten (10) of whom were directors and/or officers of the Company in the amount of \$600,333, and three (3) of whom were not directors or officers of the Company in the amount of \$260,666. The "E" Warrants are exercisable at \$5.00 per share through December 31, 2006, and none of the Warrants have been exercised. The sales of these securities to

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residents of the United States were made in reliance upon Section 4(2) of the Securities Act and Regulation D promulgated pursuant thereto, which provide exemptions for transactions not involving a public offering. The sales of these securities to non-residents of the United States were made in reliance upon Regulation S promulgated pursuant to the Securities Act, which provides an exemption for offers deemed to occur outside the United States. 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.

Exercise of Outstanding Warrants

On December 30, 2004, the Company extended by thirty-one (31) days the last day on which its unexercised "A" Warrants and "B" Warrants could be exercised from December 31, 2004 to January 31, 2005. During January 2005, 358,167 shares of our common stock were issued pursuant to warrants expiring on January 31, 2005 for cash payment in the amount of \$461,500, and 167,334 shares of our common stock were issued pursuant to warrants expiring on January 31, 2005, for debt reduction and asset exchange in the total amount of \$171,001. On January 31, 2005, "A" Warrants to purchase 8,833 shares of our stock expired without being exercised, and "B" Warrants to purchase 21,500 shares of our stock expired without being exercised.

The sales of securities above 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 creditors or stockholders of

Zion, and the shares were purchased by way of warrants held by the creditors and/or stockholders that were acquired in the connection with their prior loan to the Company or purchase or purchases of common or preferred 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.

Issuer Repurchases

We did not make any repurchases of our equity securities during the quarter ending December 31, 2004.

ITEM 6. 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 Annual 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 Annual Report and the Prospectus.

Overview

We are engaged in oil and natural gas exploration upon a single license area in the State of Israel. During the four (4) years and nine months between our formation and December 31, 2004, we have raised private equity capital in the amount of \$3,751,485 and have incurred an accumulated liability of \$1,213,116 in order to satisfy our work commitments under our agreements with the State of Israel. Over time, 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 three exceptions relating to employment stock options) have all been priced at the same price as the sales of our private equity capital. The amounts due directors, officers and key employees as of December 31, 2004 is \$847,070, which amounts to 82% of our outstanding accounts payable and accrued liabilities on that date.

Our exploration efforts have resulted in approval of our first two drilling locations, with the first drilling location being the Ma'anit #1 well. We reached an agreement with the Kibbutz Ma'anit for the rentals through August 31, 2005

(the period estimated as necessary for the drilling and testing of the Ma'anit #1 well) for a lease of the surface rights to the drill site. The rent has been paid in full. A drilling contract was negotiated and signed between the Company and Lapidoth Israel Oil Prospectors Corp. on December 29, 2004, mobilization of the rig began on or about March 15, 2005, and the re-entry and deepening of the Ma'anit #1 was commenced on April 10, 2005. With the commencement of the drilling operations on the Ma'anit #1, by letter dated April 10, 2005, the Commissioner of Petroleum Affairs extended the Ma'anit-Joseph License through April 30, 2007, subject to the submission of a satisfactory plan for a continuation of exploration in the License area within four (4) months after completion of the drilling and testing of the Ma'anit #1 well. Formal permits for the use of the drilling location and drilling operations from the Israel Lands Authority and the Haifa Regional Planning Commission have not yet been issued, although all necessary documentation has been submitted and oral confirmations received from the relevant authorities to the effect that the required permits will be issued.

Going Concern Basis

Our 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 Zion is in the development stage, we have limited capital resources, insignificant revenue to date 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 financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Liquidity and Capital Resources

Working capital (current assets minus current liabilities) was (\$636,284) and (\$695,110) at December 31, 2004 and 2003, respectively. The negative working capital is almost solely attributable to substantial amounts of deferred compensation for officers, directors and key employees, all of whom are also shareholders of Zion.

Net cash provided by financing activities was \$1,384,540 and \$326,856 for the years ended December 31, 2004 and 2003, respectively, of which \$500,000 in 2004 was in the form of loans from two (2) persons who later became directors and two (2) associates of one (1) of those persons. All \$500,000 has since been retired by exchanging the debt for shares of stock and warrants to purchase stock in the Company. The remainder of the net cash provided was from the sale of equity securities, including the exercise of outstanding warrants. Net cash used for investments was \$604,965 and \$108,970 for the years ended December 31, 2004 and 2003, respectively, of which approximately 98% in 2004 and 94% in 2003 were used for capitalized exploration costs on the license.

Looking forward to 2005, we began the year with a cash balance of \$468,409 versus \$13,264 in 2004. We also began 2005 with a drilling contract signed with Lapidoth Israel Oil Prospectors Corp. on December 29, 2004, and paid the \$60,000 deposit required at signing. Subsequently we paid an additional \$40,000 deposit to Lapidoth, deposited \$200,000 into a segregated drilling account (from which \$100,000 was paid to Lapidoth upon rig mobilization) and made an additional \$840,000 deposit into the segregated drilling account on April 10, 2005 (the date drilling of the Ma'anit #1 commenced) all as required by the drilling contract. We also have paid the \$249,898 premium for Control of Well and related insurance coverage, as well as approximately \$300,000 for completion items (casing, wellhead, etc.). On the date of filing hereof, we have a cash balance of approximately \$500,000 and we have cash receivables in the nature of Israeli Value Added Tax refunds of approximately \$180,000.

With the cash on hand, virtually no third-party debt, prospective debt financing and additional sales of equity securities, we anticipate we will have sufficient liquidity to meet our foreseeable needs.

Results of Operations

We have no revenue generating operations, as we are still a development company, however, drilling operations on the Ma'anit #1 commenced on April 10, 2005. Almost all of our net loss for the year ended December 31, 2004, comes from general and administrative expenses and the cost for the termination of Zion's initial public offering on August 30, 2004. General and administrative expenses totaled \$1,131,510, consisting of \$431,457 for legal and professional costs, \$452,149 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 \$247,904. The allocated cost for the termination of our initial public offering was \$507,380.

Critical Accounting Policies

In response to the SEC's Release No. 33-8040 "CAUTIONARY ADVICE REGARDING DISCLOSURE AND CRITICAL ACCOUNTING POLICIES", we have identified the accounting principles which we believe are most critical to the reported financial status by considering accounting policies that involve the most complex of subjective decisions or assessment.

We follow 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.

We record an investment impairment charge when we believe an investment has experienced a decline in value that is other than temporary. Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the investment that may not be reflected in an investment's current carrying value, thereby possibly requiring an impairment charge in the future.

Although our properties are in Israel and our principal operations are also expected to be there, we report all our transactions in United States Dollars. Certain of the dollar amounts in the financial statements may represent the dollar equivalent of other currencies, including the New Israeli Shekel ("NIS"), and may not be exchangeable for dollars.

We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning

strategies in assessing the need for the valuation allowance, in the event that we were to determine that it would be able to realize our deferred tax assets in the future in excess of the net recorded amount, an adjustment to the

deferred tax asset would increase net income in the period such determination was made.

We do not participate in, nor have we created, any off-balance sheet special purpose entities or other off-balance sheet financing. In addition, we do not enter into any derivative financial instruments.

We record a liability for asset retirement obligation at fair value in the period in which it is incurred and a corresponding increase in the carrying amount of the related long live assets.

Recently Issued Accounting Pronouncements

In December 2004, the FASB issued FASB Statement No. 123R, "Share-Based Payment" (FAS 123R), which requires that compensation costs relating to share-based payments be recognized in the Company's financial statements. The Company currently accounts for those payments under the recognition and measurement principles of FASB Statement No. 123, "Accounting for Stock-Based Compensation." The Company believes FAS 123R will have no impact on the Company's financial statements

In December 2004, the FASB issued FASB Statement No. 153, "Exchanges of Nonmonetary Assets, - an Amendment of APB Opinion No. 29," (FAS 153), which is effective for the Company for asset-exchange transactions beginning July 1, 2005. Under APB 29, assets received in certain types of nonmonetary exchanges were permitted to be recorded at the carrying value of the assets that were exchanged (i.e. recorded on a carryover basis). As amended by FAS 153, assets received in some circumstances will have to be recorded instead at their fair values. The Company believes the FAS 153 will have no impact on the Company's financial statements.

ITEM 7. FINANCIAL STATEMENTS

The financial statements required by this item are included at page F-1 below.

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ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 8A. 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 Annual 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 III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE SECURITIES EXCHANGE ACT OF 1934.

Executive Officers and Directors

Incorporated by reference to the following section of the Prospectus:

"MANAGEMENT" - Unchanged except for the following: (i) Ralph F. DeVore resigned as a Director on

December 30, 2004; (ii) the age of each person listed has advanced by one (1) year; (iii) at the Annual

Meeting of the Board of Directors on September 28, 2004, John Brown did not stand for re-election

as Chief Executive Officer, and was re-elected as Chairman of the Board; (iv) at the same Meeting,

Gene Soltero relinquished the office of Chief Operating Officer, he was re-elected as President and

was elected to the additional position of Chief Executive Officer; (v) all references to the Company's

initial public offering should be deleted; (vi) at the same Meeting, the Bylaws of the Company were

amended to increase the number of Directors from nine (9) to eleven (11) and redefine the responsibilities of the Chairman to clarify that an officer other than the Chairman could serve as the Company's Chief Executive Officer; and (vii) the elections of Robert Render, Richard Rinberg and James (Andy) Barron as Directors as set forth below.

Incorporated by reference to Form 8-K dated November 19, 2004, Item 5.03 with respect to amendments of the Company's bylaws.

Incorporated by reference to Form 8-K, dated November 19, 2004, Item 5.02, sub-part (3) with respect to the appointment of Robert Render as a new Director, and sub-part (4) with respect to the appointment of Richard Rinberg as a new Director.

Incorporated by reference to Form 8-K dated January 5, 2005 with respect to the resignation of Ralph F. DeVore as a Director.

At a Board meeting in Tel Aviv, Israel on April 3, 2005, Dr. James (Andy) Barron was elected as a Director of the Company. Dr. Barron is an orthodontist, living and practicing orthodontics in Temple, Texas. Upon his appointment as a Director, Dr. Barron was awarded warrants to purchase 25,000 shares of common stock of the company exercisable at \$4.00 per share at any time through December 31, 2006. As a non-management Director, Dr. Barron will receive a \$1,000 per month honorarium.

Information Regarding the Board of Directors and Committees

Our Board of Directors is divided into three (3) classes of Directors, with each class (except for the initial classes) elected to a three (3) year term every third year and holding office until their successors are elected and qualified. The class whose term of office will expire at our 2005 Annual Meeting of Shareholders consists of Eugene A. Soltero, Eitan Lubitch and Paul Oroian. The class whose term of office will expire at our 2006 Annual Meeting of Shareholders consists of John M. Brown, Z. Sheldon Fink, James (Andy) Barron and Robert Render. The class whose term of office will expire at our 2007 Annual Meeting of Shareholders consists of Philip Mandelker, Glen H. Perry, Kent S. Siegel and Richard Rinberg.

As described below, our Board of Directors has established four (4) committees: an audit committee, a compensation committee, a nominating committee and a corporate governance committee. Members of the Committees are appointed annually by the Board of Directors to serve at the discretion of the Board until their successors are appointed or the earlier of their resignation or removal.

Of the eleven (11) current members of our Board of Directors six (6) meet the criteria of independence set by the Sarbanes-Oxley Act of 2002 and SEC regulations for audit committee membership (SEC independence criteria). These are Eitan Lubitch, Z. Sheldon Fink, Paul Oroian, Kent Siegel, Richard Rinberg and Dr. Andy Barron, five (5) of whom also meet the criteria of independence set by the NASD for membership on the board of a NASDAQ market listed company (NASD independence criteria).

Audit Committee and Audit Committee Financial Expert

Incorporated by reference to the following sections of the Prospectus: "MANAGEMENT--Audit Committee", said section being unchanged. On February 24, 2004, our board of directors resolved to expand the responsibilities of the Audit Committee to include those of the Qualified Legal Compliance Committee established by the Board. On the same day our Board of Directors adopted an Audit Committee Charter. A copy of the Audit Committee Charter is available on our website at www.zionoil.com/company/corpgov.html.

Procedures for Security Holder Nominations to Board of Directors

On February 24, 2004, our board of directors adopted a charter for our Nominating Committee. See the following section of the Prospectus: "MANAGEMENT -- Nominating Committee" which is incorporated herein by reference, said section being unchanged except as follows: (i) effective September 28, 2004, and with the appointment of Eugene A. Soltero as the Chief Executive Officer, Mr. Brown currently serves only as Chairman of the Company; and (ii) with his appointment as Director on November 4, 2004, Richard Rinberg was also appointed to serve on the Nominating Committee. As Annex B to the Nominating Committee Charter, our board adopted a set of procedures for shareholder nominations to our board. A copy of the Nominating Committee Charter, including Annex B -- Shareholder Nominee Procedures, is available on our website at www.zionoil.com/company/corpgov.html.

Compliance with Section 16(a) of the Exchange Act

Until our securities are listed on a national exchange, neither Zion nor our directors, officers or beneficial owners of more than 10% of any class of Zion's equity securities are subject to reporting requirements under Section 16(a) of the Exchange Act.

Code of Ethics

We have adopted a Code of Business Conduct and Ethics applicable to each of our directors, officers and employees, including our principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions. A copy of our Code of Business Conduct and Ethics is available on our website at www.zionoil.com/company/corpgov.html.

We intend to disclose any amendment to a provision of, and the grant of any waiver of from a provision of, our Code of Business Conduct and Ethics that applies or relates to our principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions by posting such information on our website at www.zionoil.com/company/corpgov.html.

Director Compensation

Directors who are not Company employees or officers receive \$1,000 per month. Directors who are Company officers receive no extra compensation for service on the board.

Executive Officer Compensation

The following table provides the compensation of our executive officers, direct or indirect, for services rendered in all capacities for the fiscal years ended December 31, 2004, 2003, 2002 and 2001 and the period from April 6, 2000 through December 31, 2000, of which all has been paid except approximately \$2,042 to Mr. Brown, \$247,536 to Mr. Soltero, \$134,251 to Mr. Perry and \$206,360 to Mr. Mandelker:

| SUMMARY COMPENSATION TABLE | | | | | | | | |
|--------------------------------------|------|-------------|------------|--------------------------------|--------------------------------|--|-------------------|-----------------------------|
| | | | | | Long Term Compensation | | | |
| Annual Compensation | | | | | Awards | | Payouts | |
| Name and Principal Position | Year | Salary (\$) | Bonus (\$) | Other Annual Compensation (\$) | Restricted Stock Award(s) (\$) | Securities Underlying Options/SARs (#) | LTIP Payouts (\$) | All Other Compensation (\$) |
| | 2000 | - | - | - | - | - | - | - |
| John Brown Chairman | 2001 | 7,500 | - | - | - | - | - | - |
| | 2002 | 30,000 | - | - | - | - | - | - |
| | 2003 | 60,000 | 80,000 | 10,000 | - | - | - | - |
| | 2004 | 120,000 | - | - | - | - | - | - |
| | 2000 | - | - | - | - | - | - | - |
| Eugene Soltero President & CEO | 2001 | 25,000 | - | - | - | 310,000 | - | - |
| | 2002 | 60,000 | 80,000 | - | - | 100,000 | - | - |
| | 2003 | 120,000 | - | - | - | - | - | - |
| (1) | 2004 | 212,500 | - | - | - | - | - | - |
| | 2000 | 10,000 | - | - | - | - | - | - |
| Glen Perry Executive VP | 2001 | 60,000 | - | - | - | - | - | - |
| | 2002 | 60,000 | - | - | - | - | - | - |
| | 2003 | 120,000 | - | - | - | - | - | - |
| | 2004 | 200,000 | - | - | - | - | - | - |
| | 2000 | 25,000 | - | - | - | - | - | - |
| Philip Mandelker | 2001 | 63,750 | - | - | - | - | - | - |
| | 2002 | 75,000 | - | - | - | - | - | - |
| General Counsel | 2003 | 114,000 | - | - | - | - | - | - |
| | 2004 | 200,000 | - | - | - | - | - | - |

(1) Incorporated by reference to Form 8-K filed on November 19, 2004, Item 5.02, sub-part 2, with respect to the

compensation of Eugene A. Soltero being increased from \$200,000 to \$250,000 annually effective October 1, 2004, upon Mr. Soltero's election to the additional position of Chief Executive Officer at the September 28, 2004 Annual Meeting of the Board of Directors.

The executive employment agreements which have been approved by our board of directors and have been fully executed. Incorporated by reference to Prospectus - Executive Employment Arrangements and Letters of Intent.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table provides information regarding beneficial ownership of our common stock as of April 14, 2005 by:

- each person who beneficially owns more than 5% of all outstanding shares of common stock,
- each of our directors and executive officers individually, and
- all of our directors and executive officers as a group.

Except as otherwise indicated, to our knowledge, all persons listed below have sole voting power and investment power and record and beneficial ownership of their shares, except to the extent that authority is shared by spouses under applicable law. Except as noted below, all persons listed have an address in care of our principal executive offices.

The information contained in this table reflects "beneficial ownership" as defined in Rule 13d-3 of the Exchange Act. In computing the number of shares beneficially owned by a person and the percentage ownership of that person, shares of common stock subject to options and warrants held by that person (and/or pursuant to proxies held by that person) that were exercisable on April 14, 2005 or became exercisable within 60 days following that date are considered outstanding. However, such shares are not considered outstanding for the purpose of computing the percentage ownership of any other person. Percentage of ownership is based on 6,568,288 shares of common stock outstanding as of April 14, 2005. As of April 14, 2005, we had 338 holders of record of our common stock.

The address of John Brown, Eugene Soltero, Glen Perry, Paul Oroian, Kent S. Siegel, Robert Render and Dr. James (Andy) Barron is 6510 Abrams Rd., Suite 300, Dallas, TX 75214. The address of Philip Mandelker, Z. Sheldon Fink, Eitan Lubitch and Richard Rinberg is 9 Yair Stern St., Herzliya, 46412 Israel.

| Name | Amount and Nature of Beneficial Ownership | Percentage of Outstanding Common Stock |
|-------------------|---|--|
| John M. Brown | 3,257,000 (1) | 49.5% |
| Ralph DeVore | 738,147 (2) | 11.2% |
| Philip Mandelker | 508,783 (3) | 7.7% |
| Eugene A. Soltero | 496,208 | 7.5% |
| Glen Perry | 471,000 (4) | 7.2% |
| Robert Render | 146,500 (5) | 2.2% |
| Richard Rinberg | 141,000 (6) | 2.1% |

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| | | | |
|--|-----------|------|-------|
| James Barron | 129,000 | (7) | 2.0% |
| Kent S. Siegel | 32,875 | (8) | 0.5% |
| Eitan Lubitch | 30,250 | (9) | 0.5% |
| Z. Sheldon Fink | 28,500 | (10) | 0.4% |
| Paul Oroian | 28,500 | (10) | 0.4% |
| All directors and executive officers as a group (11 persons) | 4,138,399 | (11) | 60.7% |

(1)

Includes (a) 100,000 shares of common stock owned by Mr. Brown's wife; (b) 2,665,500 shares of common stock owned by others for which Mr. Brown holds voting proxies, including the 100,000 shares owned by his wife; and (c) warrants to purchase 16,000 share ⁽²⁾Includes 522,531 shares of common stock owned by others for which Mr.

DeVore holds voting proxies. ⁽³⁾ Includes warrants to purchase 1,500 shares of common stock until December 31, 2006 at an average price of \$5.00 per share and 400,000 shares of common stock owned by a trust for Mr. Mandelker and his family. (4) Includes warrants to purchase 5,000 shares of common stock until December 31, 2006 at an average price of \$5.00 per share.

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(5) Includes warrants to purchase 85,000 shares of common stock until December 31, 2006 at an average price of \$3.76 per share. (6) Includes warrants to purchase 46,000 shares of common stock until December 31, 2006 at an average price of \$4.02 per share. (7) Includes (a) 45,000 shares held by trusts for Dr. Barron's children and (b) warrants to purchase 35,000 shares of common stock until December 31, 2006 at an average price of \$3.57 per share. (8) Includes (a) warrant to purchase 25,000 shares of common stock until December 31, 2005 at \$3.00 per share, (b) warrant to purchase 1,000 shares of common stock until December 31, 2006 at \$5.00 per share, and (c) the following securities held by Mr. Siegel (9) Includes (a) warrant to purchase 25,000 shares of common stock until December 31, 2005 at \$3.00 per share and (b) warrant to purchase 1,500 shares of common stock until December 31, 2006 at \$5.00 per share. (10) Includes (a) warrant to purchase 25,000 shares of common stock until December 31, 2005 at \$3.00 per share and (b) warrant to purchase 1,000 shares of common stock until December 31, 2006 at \$5.00 per share. (11) Includes (a) warrants to purchase 100,000 shares of common stock at \$3.00 per share until December 31, 2005, (b) warrants to purchase 75,000 shares of common stock at \$4.00 per share until December 31, 2006, and (c) warrants to purchase 102,000 shares of common stock at \$5.00 per share until December 31, 2006.

Changes in Control

We are not aware of any arrangement that may result in a change of control of Zion.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Incorporated by reference to the following section of the Prospectus: "CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS", said section being unchanged except as follows: (i) modification of the Cimarron loan facility as described in Form 8-K filed on November 19, 2004, Item 5.02, sub-part 2, which is incorporated herein by reference, (ii) the \$100,000 loan facility advanced by Ms. Irith Rappaport, a shareholder of Zion has been renewed and extended to June 30, 2005 and the Lender granted an option to convert the loan into common shares at a price of \$4.00 per share; (iii) the relationship of Robert Render as a lender to the Company, as well as a consultant, director and shareholder of the Company, all as described in Form 8-K filed on November 19, 2004, Item 5.02, sub-part 3, which is incorporated herein by reference; (iv) the relationship of Richard Rinberg as a lender to the Company, as well as a director and shareholder of the Company, all as described in Form 8-K filed on November 19, 2004, Item 5.02, sub-part 4, which is incorporated herein by reference; (v) with the signing of employment agreements effective January 1, 2004, Eugene A. Soltero and Glen H. Perry are no longer paid as consultants to the Company, but as employees as described at Item 10. EXECUTIVE COMPENSATION above; and (vi) the Board of Directors was expanded from nine (9) to eleven (11) members at the Annual Meeting of the Board of Directors on September 28, 2004, currently a majority (6) of the Directors meet the independence criteria of the SEC

and five meet the independence criteria of the NASD.

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K.

Reports on Form 8-K

A report on Form 8-K was filed on November 19, 2004. The events reported were:

- Item 1.01: Extension of Work Program Schedule and Conditional Extension of License.
- Item 3.02: Unregistered Sales of Equity Securities.
- Item 5.02: Departure of Principal Officer; Election of Directors; Appointment of Principal Officer
- Item 5.03: Amendments to Bylaws

A report on Form 8-K was filed on January 5, 2005. The events reported were:

- Item 1.01: Entry into a Material Definition Agreement - Drilling Contract.
- Item 3.02: Unregistered Sales of Equity Securities.
- Item 3.03: Material Modifications of Rights of Security Holders
- Item 5.02: Resignation of Director.

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Exhibit Index

- 3.1 Amended and Restated Certificate of Incorporation of Zion Oil & Gas, Inc. (incorporated by reference to Exhibit 3.1 to the Registration Statement.)
- 3.2 Amended and Restated Bylaws of Zion Oil & Gas, Inc. (incorporated by reference to Exhibit 3.1 to the Form 8-K filed on November 19, 2004.)
- 9.1 Stockholders' and Voting Agreement (with John M. Brown) (incorporated by reference to Exhibit 9.1 to the Registration Statement.)
- 9.2 Stockholders' and Voting Agreement (with Ralph DeVore) (incorporated by reference to Exhibit 9.2 to the Registration Statement.)
- 10.1 (i) Ma'anit Joseph License (incorporated by reference to Exhibit 10.1 to the Registration Statement)
- (ii) Extension of the Ma'anit Joseph License dated April 10, 2005
- 10.2 (i) Employment Agreement dated as of January 1, 2004, between Zion Oil & Gas, Inc. and John M. Brown (incorporated by reference to Exhibit 10.2 to the

Registration Statement.)

- (ii) Employment Agreement dated as of January 1, 2004, between Zion Oil & Gas, Inc. and Eugene A. Soltero (incorporated by reference to Exhibit 10.2 of the Registration Statement.)
 - (iii) Letter Amendment dated as of October 1, 2004, between Zion Oil & Gas, Inc. and Eugene A. Soltero
 - (iv) Employment Agreement dated as of January 1, 2004, between Zion Oil & Gas, Inc. and Glen H. Perry (incorporated by reference to Exhibit 10.2 of the Registration Statement.)
 - (v) Retention Agreement dated as of January 1, 2004, between Zion Oil & Gas, Inc. and Philip L. Mandelker (incorporated by reference to Exhibit 10.2 of the Registration Statement.)
- 10.3
- (i) Loan Agreement dated as of Feb. 25, 2003, between Zion Oil & Gas, Inc. and Irith Rappaport (incorporated by reference to Exhibit 10.3 of the Registration Statement.)
 - (ii) Non-Negotiable Promissory Note dated Feb. 25, 2003 from Zion Oil & Gas, Inc. to Irith Rappaport (incorporated by reference to Exhibit 10.3 of the Registration Statement.)
 - (iii) Letter Amendment dated Feb. 1, 2004 to the Loan Agreement dated 25 February 2003. (incorporated by reference to Exhibit 10.3 of the Registration Statement.)
 - (iv) Extension of Loan Agreement from Dec. 31, 2004 to June 30, 2005.
- 24.1 Power of Attorney
- 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

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Lane Gorman Trubitt L.L.P. served as our independent accountants for the years ended December 31, 2003 and 2004. Principal accounting fees for professional services rendered for us by Lane Gorman & Trubitt for the years ended December 31, 2003 and 2004 are summarized as follows:

| | 2003 | 2004 |
|-------------------|---------------|--------------|
| Audit (1) | 24,449.00 | 30,751 |
| Audit Related (2) | 2,660.00 | 0.00 |
| Tax (3) | 2,500.00 | 2,730.00 |
| All other | <u>140.00</u> | <u>0.00</u> |
| Total | \$ 29,749.00 | \$ 33,481.00 |

- (1) Reflects fees for professional services rendered in connection with audits and quarterly reviews of financial statements of Zion and review of and preparation of consents for the Prospectus and statutory and regulatory filings. It does not reflect additional fees of \$7,750 for 2003 and \$7,750 for 2004 billed by KPMG -- Somekh Chaikin, certified accountants, for audits of our Israeli operations.
- (2) Reflects fees, if any, for assurance and consulting services to our financial statements and reviews of our quarterly statements.
- (3) Reflects fees for services for tax compliance for the preparation of our U.S. tax returns. It does not reflect additional fees of \$1,000 for 2003 and \$1,000 for 2004 billed by KPMG -- Somekh Chaikin, certified accountants, for services in connection with the preparation of our Israeli tax returns.

Audit Committee Pre-Approval Policies and Procedures

Our Audit Committee considers and pre-approves any audit and non-audit engagement or relationship between Zion and any independent accountant. The Audit Committee has delegated to the Chairman of the Committee the authority to pre-approve all audit or non-audit services to be provided by an independent accountant if presented to the full Committee at its next meeting. In accordance with these procedures, the engagement of Lane Gorman & Trubitt L.L.P. to conduct the audit of our 2004 financial statements, was pre-approved by the Chairman of our Committee and approved by the Audit Committee. Lane Gorman Trubitt, L.L.P. has provided non-audit services to us in the amount of \$2,640 during 2003 and \$_____ during 2004.

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.

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(Registrant)

| | | | |
|-------|---|-------|---|
| By: | <u>/s/ Eugene A. Soltero</u> | By: | <u>/s/ William H. Avery</u> |
| | Eugene A. Soltero | | William H. Avery, Vice-President - Finance |
| | President and Chief Executive Officer (Principal Executive Officer) | | (Principal Financial and Accounting Officer) |
| Date: | April 15, 2005 | Date: | April 15, 2005 |

In accordance with the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed below by the following persons in the capacities and on the dates indicated:

/s/ John M. Brown Chairman of the Board April 15, 2005

John M. Brown

/s/ E. A. Soltero President , Chief Executive Officer and Director April 15, 2005

Eugene A. Soltero

_____*_____ Executive Vice President and Director April 15, 2005

Glen H. Perry

_____*_____ General Counsel, Secretary and Director April 15, 2005

Philip Mandelker

_____*_____ Director April 15, 2005

Robert Render

_____ Director April 15, 2005

Eitan Lubitch

_____ Director April 15, 2005

Z. Sheldon Fink

_____ Director April 15, 2005

Paul Oroian

_____ * _____ Director April 15, 2005

Kent S. Siegel

_____ Director April 15, 2005

Richard Rinberg

_____ Director April 15, 2005

James (Andy) Barron

* By: /s/ E. A. Soltero

Eugene A. Soltero, Attorney-in-Fact

ZION OIL & GAS, INC.
FINANCIAL STATEMENTS
AND REPORT OF INDEPENDENT
CERTIFIED PUBLIC ACCOUNTANTS
DECEMBER 31, 2004 AND 2003

INDEX TO FINANCIAL STATEMENTS

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| Balance Sheets - December 31, 2004 and 2003 | F-3 |
| Statements of Operations for the Years Ended December 31, 2004 and 2003 | F-4 |
| Statement of Changes in Stockholders' Equity | F-5 |
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Report of Independent Certified Public Accountants

Lane Gorman Trubitt, L.L.P.

[to be filed by amendment]

F-2

ZION OIL & GAS, INC.
(A Development Stage Company)

BALANCE SHEETS

December 31,

ASSETS

| | <u>2004</u> | <u>2003</u> |
|--|---------------------|---------------------|
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 468,409 | \$ 13,264 |
| Prepaid expenses and other | 18,284 | 2,067 |
| Refundable value-added tax | <u>14,036</u> | <u>18</u> |
| Total current assets | <u>500,729</u> | <u>15,349</u> |
| UNPROVED OIL AND GAS PROPERTIES | 1,394,938 | 796,463 |
| PROPERTY AND EQUIPMENT | | |
| net of accumulated depreciation of \$405 and \$336 | 14,439 | 8,029 |
| OTHER ASSETS | | |
| Cost associated with public offering | - | 251,420 |
| Assets held for severance benefits | <u>4,668</u> | <u>4,237</u> |
| Total other assets | <u>4,668</u> | <u>255,657</u> |
| Total assets | <u>\$ 1,914,774</u> | <u>\$ 1,075,498</u> |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | | |
|--|------------------|----------------|
| CURRENT LIABILITIES | | |
| Notes payable to related parties | \$ 103,882 | \$ 95,000 |
| Accounts payable and accrued liabilities | 1,009,402 | 609,387 |
| Accrued liabilities | <u>23,729</u> | <u>6,072</u> |
| Total current liabilities | <u>1,137,013</u> | <u>710,459</u> |
| NOTES PAYABLE TO RELATED PARTIES, LESS CURRENT MATURITIES | 40,118 | 43,500 |
| PROVISION FOR SEVERANCE PAY, NET | 35,985 | 11,333 |
| STOCKHOLDERS' EQUITY | | |
| Common stock, par value \$.01; 20,000,000 shares authorized; 2004 5,537,787 shares; 2003 4,858,851 shares issued and outstanding | 55,378 | 48,589 |
| Additional paid-in capital | 3,696,107 | 1,636,200 |

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| | | |
|--|---------------------|---------------------|
| Deficit accumulated in development stage | <u>(3,049,827)</u> | <u>(1,374,583)</u> |
| Total stockholders' equity | <u>701,658</u> | <u>310,206</u> |
| Total liabilities and stockholders' equity | <u>\$ 1,914,774</u> | <u>\$ 1,075,498</u> |

The accompanying notes are an integral part of these financial statements

F-3

ZION OIL & GAS, INC.
(A Development Stage Company)
STATEMENTS OF OPERATIONS

| | Year Ended <u>December 31, 2004</u> | Year Ended <u>December 31,</u> <u>2003</u> | Period from April 6, 2000 (inception) to <u>December 31, 2004</u> |
|--|--|--|---|
| REVENUE | \$ - | \$ - | \$ - |
| GENERAL AND ADMINISTRATIVE EXPENSES | | | |
| Legal and Professional | 431,457 | 585,825 | 1,447,443 |
| Salaries | 452,149 | 80,007 | 575,479 |
| Other | <u>247,904</u> | <u>131,837</u> | <u>461,842</u> |
| Loss from operations | (1,131,510) | (797,669) | (2,484,764) |
| OTHER INCOME (EXPENSE) | | | |
| Termination of initial public offering | (507,380) | - | (507,380) |
| Interest expense | <u>(36,354)</u> | <u>(17,645)</u> | <u>(57,683)</u> |
| Loss before income tax | (1,675,244) | (815,314) | (3,049,827) |
| Income taxes | = | = | = |
| NET LOSS | <u>\$ (1,675,244)</u> | <u>\$ (815,314)</u> | <u>\$ (3,049,827)</u> |
| NET LOSS PER SHARE OF COMMON STOCK - | | | |

| | | | |
|------------------------------------|-----------|-----------|-----------|
| BASIC AND DILUTED | \$ (0.33) | \$ (0.19) | \$ (1.35) |
| WEIGHTED-AVERAGE SHARES | | | |
| OUTSTANDING - BASIC AND DILUTED | 5,006,390 | 4,220,500 | 2,254,822 |

The accompanying notes are an integral part of these financial statements

F-4

ZION OIL & GAS, INC.
(A Development Stage Company)
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Period from April 6, 2000 (inception) to December 31, 2004

| | <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>Development</u> | |
| | | | | | | <u>Stage</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 | - | - | - | - | (22,250) | - | (22,250) |
| Net loss | = | = | = | = | = | (5,364) | (5,364) |

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| | | | | | | | |
|--|---|---|-----------|-----|----------|------------------|------------------|
| Balances, December 31, 2000 | - | - | 2,500,000 | 250 | 79,900 | (5,364) | 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 | - | - | - | - | (84,676) | - | (84,676) |
| Net loss | = | = | = | = | = | <u>(166,753)</u> | <u>(166,753)</u> |
| Balances, December 31, 2001 | - | - | 3,000,000 | 300 | 495,174 | (172,117) | 323,357 |

(Continued on following page)

The accompanying notes are an integral part of these statements

ZION OIL & GAS, INC.
(A Development Stage Company)
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Period from April 6, 2000 (inception) to December 31, 2004
(Continued)

| | <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>Development</u> | <u>Total</u> |
| | | | | | | <u>Stage</u> | |
| Change in par value of common shares 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 | - | - | 253,746 | - | 254,000 |
| Payment of accounts payable through issuance of shares and warrants | 12,700 | 127 | 532,500 | 5,325 | 334,048 | - | 339,500 |
| Payment of note payable through issuance of shares and warrants | 5,000 | 50 | - | - | 49,950 | - | 50,000 |
| Costs associated with the issuance of shares | - | - | - | - | (159,449) | - | (159,449) |
| Net loss | = | = | = | = | = | <u>(387,152)</u> | <u>(387,152)</u> |

Balances, December 31,
2002 43,100 \$ 431 3,552,500 \$ 35,525 \$ 963,569 \$ (559,269) \$ 440,256

(Continued on following page)

The accompanying notes are an integral part of these statements

F-6

ZION OIL & GAS, INC.
(A Development Stage Company)
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Period from April 6, 2000 (inception) to December 31, 2004
(Continued)

| | <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>Development</u> | |
| | | | | | | <u>Stage</u> | |
| Issuance of shares in connection with executive employment | - | -- | 50,000 | 500 | 49,500 | - | 50,000 |
| Issuance of shares on | - | - | 165,000 | 1,650 | 31,350 | - | 33,000 |

warrants exercise

Issuance of dividend
shares torecord holders as of
December 31, 2002

| | | | | | | |
|-------|----|---|---|------|---|---|
| 4,310 | 43 | - | - | (43) | - | - |
|-------|----|---|---|------|---|---|

Issuance of shares and
warrants in
a private offering which
closed inFebruary 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 |
| | - | - | 124,083 | 1,241 | 142,217 | - | 143,458 |

for reduction of accounts
payable

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) |
|---|---|---|---|----------|---|----------|

Net loss

| | | | | | | |
|---|---|---|---|---|-----------|-----------|
| = | = | = | = | = | (815,314) | (815,314) |
|---|---|---|---|---|-----------|-----------|

Balances, December 31,
2003

| | | | | | | |
|---|---|------------------|------------------|------------------|-----------------------|-------------------|
| = | = | <u>4,848,851</u> | <u>\$ 48,859</u> | <u>1,636,200</u> | <u>\$ (1,374,583)</u> | <u>\$ 310,206</u> |
|---|---|------------------|------------------|------------------|-----------------------|-------------------|

(Continued on following page)

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

Period from April 6, 2000 (inception) to December 31, 2004

(Continued)

| | <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>Development</u> | |
| | | | | | | <u>Stage</u> | |
| Issuance of shares on warrants exercise | - | - | 122,000 | 1,225 | 182,525 | - | 183,750 |
| Issuance of shares and warrants in a private offering | - | - | 263,083 | 2,631 | 1,007,619 | - | 1,010,250 |
| Payment of officer salaries through | | | | | | | |

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| | | | | | | | |
|--|---|---|------------------|------------------|------------------|-----------------------|--------------------|
| issuance of shares and warrants | - | - | 114,603 | 1,146 | 278,050 | - | 279,196 |
| 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 fee through issuance of shares and warrants | - | - | 7,500 | 75 | 29,925 | - | 30,000 |
| 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) |
| Net loss | = | = | = | = | = | <u>(1,675,244)</u> | <u>(1,675,244)</u> |
| Balances, December 31, 2004 | = | = | <u>5,537,787</u> | <u>\$ 55,378</u> | <u>3,696,827</u> | <u>\$ (3,049,827)</u> | <u>\$ 701,658</u> |

The accompanying notes are an integral part of these statements

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ZION OIL & GAS, INC.

(A Development Stage Company)

STATEMENTS OF CASH FLOWS

Period from

Year Ended

Year Ended

April 6, 2000 (inception) to

December 31, 2004

December 31, 2003

December 31, 2004

CASH FLOWS FROM OPERATING ACTIVITIES

Net loss

\$ (1,675,244)

\$ (815,314)

\$ (3,049,827)

Adjustments to reconcile net loss to net cash provided

(used) in operating activities

Depreciation

80

69

32

| | |
|---|-----------|
| | 485 |
| Officer, director and other fees, paid via common stock | |
| | 364,196 |
| | 60,000 |
| | 424,196 |
| Interest paid through issuance of common stock | |
| | 17,500 |
| | - |
| | 17,500 |
| Write-off of costs associated with public offering | |
| | 507,380 |
| | - |
| | 507,380 |
| Change in assets and liabilities: | |
| Refundable value-added tax | |
| | (14,018) |
| | (5,024) |
| | (14,036) |
| Prepaid expenses and other | |
| | (16,217) |
| | - |
| | (18,284) |
| Accounts payable | |
| | 450,015 |
| | 501,066 |
| | 1,451,891 |

| | |
|--|--------------------|
| Accrued liabilities | 17,657 |
| | 6,072 |
| | 23,729 |
| Severance pay | <u>24,221</u> |
| | <u>6,325</u> |
| | <u>31,317</u> |
| Net cash provided/(used) in operating activities | <u>(324,430)</u> |
| | <u>(236,758)</u> |
| | <u>(625,649)</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES | |
| Acquisition of property and equipment | (6,490) |
| | (7,042) |
| | (14,924) |
| Investment in oil and gas properties | <u>(598,475)</u> |
| | <u>(101,928)</u> |
| | <u>(1,394,938)</u> |
| Net cash used in investing activities | <u>(604,965)</u> |
| | <u>(108,970)</u> |
| | <u>(1,409,862)</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES | |

| | |
|---|------------------|
| Loan proceeds - related party | 11,000 |
| | 106,192 |
| | 258,620 |
| Loan principal repayments - related party | (5,500) |
| | (18,282) |
| | (77,160) |
| Loan proceeds -- other | 500,000 |
| | - |
| | 500,000 |
| Proceeds from sale of stock | 1,194,000 |
| | 362,750 |
| | 2,307,150 |
| Financing costs of issuing stock | <u>(314,960)</u> |
| | <u>(87,804)</u> |
| | <u>(484,690)</u> |
| Net cash provided by financing activities | <u>1,384,540</u> |
| | <u>326,856</u> |
| | <u>2,503,920</u> |
| NET INCREASE (DECREASE) IN CASH | 455,145 |

| | |
|----------------------------|-------------------|
| | (18,872) |
| | 468,409 |
| Cash - Beginning of period | |
| | <u>13,264</u> |
| | <u>32,136</u> |
| | = |
| Cash - End of period | |
| | <u>\$ 468,409</u> |
| | <u>\$ 13,264</u> |
| | <u>\$ 468,409</u> |

(Continued on following page)

The accompanying notes are an integral part of these statements

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

| | Year Ended <u>December</u> <u>31, 2004</u> | Year Ended <u>December 31,</u> <u>2003</u> | Period from April 6, 2000 (inception) to <u>December 31, 2004</u> |
|---|--|--|--|
| SUPPLEMENTAL INFORMATION | | | |
| Cash paid for interest | \$ 16,050 | \$ 13,502 | \$ 16,829 |
| Cash paid for income taxes | - | - | - |
| Payment of accounts payable through issuance of preferred and common stock | 50,000 | 356,998 | 786,498 |
| Payment of note payable through issuance of common stock | 500,000 | - | 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 | - | 222,100 | 381,687 |

The accompanying notes are an integral part of these financial statements

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Zion Oil & Gas, Inc.

NOTES TO FINANCIAL STATEMENTS

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 the 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 the Zion Florida were converted into equivalent warrants and options of the Company.

The Company holds a petroleum exploration license on approximately 95,800 acres of unproved properties in north-central Israel called the "Ma'anit-Joseph License", issued to the Company by the state of Israel. The primary term on the license expires April 30, 2005 and it contains a commitment to start the drilling or re-entry of a well on or before the later of (a) March 1, 2005 or (b) forty-five (45) days following the receipt of notice of rig availability from the drilling contractor. Re-entry of the Ma'anit #1 well began on April 10, 2005. Because re-entry of the well commenced prior to April 30, 2005, the Company became entitled to receive, and effective April 10, 2005 has received, an extension of the License through April 30, 2007, subject to completion of the drilling and testing of the Ma'anit well and submission of a satisfactory plan for continuation of exploration in the License Area. On December 29, 2004, the Company signed a drilling contract with Lapidoth Israel Oil Prospectors Corp., Ltd. (the "Drilling Contract") which provides for commencement of the re-entry and deepening of the Ma'anit #1 well to a depth of between 4,000 and 5,000 meters on the later of (a) March 15, 2005 or (b) forty-five (45) days following release of the rig from its current project. The Drilling Contract was submitted to the Israeli Petroleum Commissioner (the "Commissioner") and found to be in compliance with the terms of the License. The Company holds net assets of \$910,403 in Israel. The net loss associated with operations in Israel was \$121,043 and \$90,162 for the years ended December 31, 2004 and 2003 respectively. The net loss associated with U.S. operations was \$1,554,201 and \$725,152 for the years ended December 31, 2004 and 2003, respectively.

Operations in Israel are conducted through a branch office and the License is held directly in the name of the Company.

Basis of Presentation

The 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, insignificant 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 and, ultimately, to achieve profitable operations. The uncertainty of these conditions raises substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Management Presentation

On February 11, 2004, the Company filed a registration statement with the Securities and Exchange Commission 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 which 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.

Management plans to continue to raise capital through debt and private offerings. Management intends to continue to use the proceeds from debt and/or equity sales to explore for and develop oil and gas reserves in Israel. The Company believes that these actions will enable the Company to carry out its business plan and ultimately to achieve profitable operations.

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 Company uses the dollar as its functional and reporting currency. Certain of the dollar amounts in the financial statements may represent the dollar equivalent of other currencies, including the New Israeli Shekel ("NIS"), and may not be exchangeable for dollars.

Cash

The Company maintains its cash balance at two banks with one bank located in the United States and one bank located in Israel. The account at the bank located in the United States is insured by the Federal Deposit Insurance Corporation up to \$100,000. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk on cash and cash equivalents.

For purposes of the statement of cash flows, the Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

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.

Abandonments of properties are accounted for as adjustments to capitalized costs with no loss recognized. During the years ending December 31, 2004 and 2003, 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.

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 five to ten years using accelerated methods. Depreciation charged to expense amounted to \$80 and \$69 for the years ended December 31, 2004 and 2003, respectively, and \$485 for the period April 6, 2000 (inception) to December 31, 2004.

Zion Oil & Gas, Inc.

NOTES TO FINANCIAL STATEMENTS

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Long-Lived Assets

Long-lived assets, other than oil and gas properties, are periodically reviewed for impairment based on an assessment of future operations. The Company records impairment losses on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets'

carrying amount. Measurement of an impairment loss is based on the fair market value of the asset. Impairment for oil and gas properties is computed in the manner described above under "Oil and Gas Properties."

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 a reduction to the paid-in capital attributable to the offering. As of December 31, 2003, \$251,420 of equity offering costs were attributable to the public offering of common stock pursuant to a registration statement filed with the Securities and Exchange Commission on February 11, 2004. On August 31, 2004 the Company charged to expense \$507,380 associated with the registration statement filed with the Securities and Exchange Commission on February 11, 2004 which was terminated. Included as a reduction to paid-in capital during 2004 and 2003 is \$59,000 and \$58,484 associated with private offerings of common stock.

Income Taxes

Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due, if any, plus net deferred taxes related primarily to differences between the bases of assets and liabilities for financial and income tax reporting. Deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets include recognition of operating losses that are available to offset future taxable income and tax credits that are available to offset future income taxes. Valuation allowances are recognized to limit recognition of deferred tax assets where appropriate. Such allowances may be reversed when circumstances provide evidence that the deferred tax assets will more likely than not be realized.

Revenue Recognition

Revenue is accrued and recognized in the month the oil and gas is produced and sold. Reimbursement of costs from well operations is netted against the related oil and gas production expenses.

Stock-Based Compensation

Prior to 2003, the Company accounted for stock-based compensation under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25) and related interpretations. No stock-based employee compensation expense for stock options was reflected in net income for the year ended December 31, 2004, as all stock options granted under those plans had an exercise price equal to or greater than the fair market value of the underlying common stock on the date of the grant. Effective January 1, 2003, the Company adopted the preferable fair value recognition provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). The Company selected the prospective method of adoption described in Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*. Compensation cost recognized in 2003 and 2002 is the same as that which would have been recognized had the fair value method of SFAS No. 123 been applied from its original effective date. In accordance with the prospective method of adoption, results for years prior to 2003 have not been restated.

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Zion Oil & Gas, Inc.

NOTES TO FINANCIAL STATEMENTS

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

New Accounting Standards

In December 2004, the FASB issued FASB Statement No. 123R, "Share-Based Payment" (FAS 123R), which requires that compensation costs relating to share-based payments be recognized in the Company's financial statements. The Company currently accounts for those payments under the recognition and measurement principles of FASB Statement No. 123, "Accounting for Stock-Based Compensation." The Company believes FAS 123R will have no impact on the

Company's financial statements.

In December 2004, the FASB issued FASB Statement No. 153, "Exchanges of Nonmonetary Assets, - an Amendment of APB Opinion No. 29," (FAS 153), which is effective for the Company for asset-exchange transactions beginning July 1, 2005. Under APB 29, assets received in certain types of nonmonetary exchanges were permitted to be recorded at the carrying value of the assets that were exchanged (i.e. recorded on a carryover basis). As amended by FAS 153, assets received in some circumstances will have to be recorded instead at their fair values. The Company believes the FAS 153 will have no impact on the Company's financial statements.

Use of Estimates

The preparation of the Company's consolidated financial statements in conformity with generally accepted accounting principles requires the Company to make estimates and assumptions that affect the amounts reported in these financial statements and accompanying notes. Actual results could differ from those estimates.

3. PROVISION FOR SEVERANCE PAY

Under Israeli law and labor agreements, an Israeli employer is required to make severance payments to its dismissed

Israeli employees and to Israeli employees who leave its employment under certain circumstances.

The liability in respect of certain of the Company's employees is discharged in part by

- a. 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.

- b. 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

- c. 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 income (expenses) in respect of severance pay for the year ended December 31, 2004

- d. and 2003 and the period from April 6, 2000 to December 31, 2004 amounted to \$28,221, \$6,325 and \$31,317, respectively.

- e. Withdrawals from the funds may be made only upon termination of employment.

The Company's liability for termination of the employer-employee relationship is

- f. composed as follows at December 31,:

| | 2004 | 2003 |
|---|------------------|-----------------|
| Provision for severance pay | \$ 35,985 | \$11,333 |
| Amounts funded including accumulated income | <u>4,668</u> | <u>4,237</u> |
| | <u>\$ 31,317</u> | <u>\$ 7,096</u> |

Zion Oil & Gas, Inc.

NOTES TO FINANCIAL STATEMENTS

4. STOCKHOLDERS' EQUITY

The Company has reserved 977,334 shares of common stock as of December 31, 2004 for the exercise of warrants. These warrants have been excluded from earnings per share calculations because they are anti-dilutive at December 31, 2004 and 2003. These warrants could potentially dilute basic earnings per share in future years. The warrants exercise prices and expiration dates are as follows:

| Exercise <u>Price</u> | Number <u>of Shares</u> | Expiration <u>Date</u> |
|--------------------------|----------------------------|---------------------------|
| \$ 1.00 | | |
| | 378,834 | |
| | | January 31, 2005 |
| 1.50 | | |
| | 197,000 | |
| | | January 31, 2005 |
| 3.00 | | |
| | 130,000 | |
| | | December 31, 2005 |
| 3.00 | | |
| | 40,000 | |
| | | December 31, 2006 |
| 4.00 | | |
| | 50,000 | |
| | | December 31, 2006 |
| 5.00 | | |
| | <u>181,500</u> | |
| | | December 31, 2006 |

977,344

| | <u>Number of Shares</u> | <u>Weighted Average Exercise Price</u> |
|-----------------------------------|-----------------------------|--|
| Granted to: | | |
| Employees, officers and directors | 325,270 | 1.66 |
| Others | 65,500 | 1.50 |
| Expired/canceled | - | - |
| Exercised | <u>(382,583)</u> | <u>.76</u> |
| Outstanding, December 31, 2003 | 898,520 | 1.42 |
| Granted to: | | |
| Employees, officers and directors | 90,000 | 4.72 |
| Others | 211,500 | 4.22 |
| Expired/canceled | - | - |
| Exercised | <u>(222,686)</u> | <u>1.36</u> |
| Outstanding, December 31, 2004 | <u>977,334</u> | 2.34 |

In connection with the recapitalization merger on July 9, 2003, all outstanding options were converted to warrants. If not previously exercised, of those outstanding at December 31, 2003, warrants to purchase 798,520 shares of common stock will expire on December 31, 2004 and warrants to purchase 100,000 shares will expire on December 31, 2005.

The fair value of each warrant granted was estimated on the date of grant using the Minimum Value option-pricing model with the following assumptions:

| | |
|---------------------------|-------|
| Risk-free interest rate | 2.00% |
| Expected dividends | - |
| Expected terms (in years) | 3.0 |

Compensation cost is determined based on the fair value at the grant dates for awards. The fair value and compensation cost associated with grants of warrants during 2004 and 2003 is \$0 for each year. The fair values generated by the

Minimum Value model may not be indicative of the future benefit, if any, that may be received by the option or warrant holder.

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Zion Oil & Gas, Inc.

NOTES TO FINANCIAL STATEMENTS

5. RELATED PARTY TRANSACTIONS

Notes payable to related parties includes \$44,000 under a loan facility with Cimarron Resources, Inc. (Cimarron) a company owned by the President 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 (4.25% at December 31, 2004) 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.

Notes payable to related parties includes a \$100,000 note payable under a line of credit loan agreement with a shareholder of the Company in the maximum amount of \$100,000 to be repaid out of the first \$200,000 in receipts from a public offering, or on June 30, 2005, which ever occurs first. Any outstanding balance may be converted at the election of the lender to shares of common stock 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 1,000 shares of preferred stock and warrants to purchase 5,000 shares of the Company's common stock.

On June 30, 2004 and August 25 and 31, 2004, pursuant to a loan agreement dated June 30, 2004, the Robert E. Render Trust (the "Render Trust") a trust controlled by Mr. Robert Render (who was, on September 28, 2004, elected a director of the Company) loaned the Company \$100,000, \$80,000 and \$20,000 respectively (\$200,000 in the aggregate)(each such loan, a "Render Loan" and collectively the "Render Loans"). Each Render Loan bore interest at the rate of 10% annually and was due March 2, 2005, subject to Mr. Render's right to convert each Render Loan into a five year amortized term loan. In connection with each Render Loan, the Company granted the Render Trust a warrant to purchase respectively 20,000, 16,000 and 4,000 (40,000 in the aggregate) shares of common stock of the Company at \$3.00 per share exercisable at any time between January 1 and December 31, 2006. On September 30, 2004, the Render Trust forgave all of the Render Loans in consideration for 50,000 shares of common stock of the Company and warrants to purchase 20,000 shares of common stock of the Company at \$5.00 per share, exercisable at any time through December 31, 2006.

Principal payments on notes payable to related parties are as follows for each of the future years ending December 31,:

| | |
|------|------------------|
| 2005 | \$103,882 |
| 2006 | 3,989 |
| 2007 | 4,203 |
| 2008 | 4,430 |
| 2009 | 4,668 |
| 2010 | <u>22,828</u> |
| | <u>\$144,000</u> |

Included in accounts payable at December 31, 2004 and 2003 are payables to officers and directors of the Company totaling \$847,070 and \$248,162, respectively for salaries, consulting services, bonuses and reimbursement of expenses.

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Zion Oil & Gas, Inc.

NOTES TO FINANCIAL STATEMENTS

6. INCOME TAXES

The Company's deferred tax assets (liabilities) consist of the following:

| | <u>December 31, 2004</u> | <u>December 31, 2003</u> |
|------------------------------------|--------------------------|--------------------------|
| Deferred tax assets (liabilities): | | |
| Net operating loss carry forwards | \$ 1,627,372 | \$ 809,815 |
| Unproved oil & gas properties | <u>(505,246)</u> | <u>(288,854)</u> |
| | 1,122,126 | 520,961 |
| Less valuation allowance | <u>(1,122,126)</u> | <u>(520,961)</u> |
| Net deferred tax assets | \$ _____ - | \$ _____ - |

The difference from the expected income tax expense for the year ended December 31, 2004 at the statutory federal tax rate of 34% for the United States of America and 35% for Israel and the actual income tax expense is primarily the result of net operating loss carryforwards and temporary differences between financial statement and income tax recognition of depreciation and amortization.

The valuation allowance was established to reduce the deferred tax asset for the amounts that more likely than not will not be realized. This reduction is primarily necessary due to the uncertainty of the Company's ability to utilize all of the net operating loss carryforwards. The valuation allowance increased \$601,165 and \$307,077 in 2004 and 2003, respectively.

At December 31, 2004, the Company has available net operating loss carryforwards of approximately \$3,055,000 to reduce future U. S. taxable income. These carryforwards expire from 2020 to 2025.

Income earned from activities in Israel is subject to regular Israeli tax rates. For Israeli tax purposes, exploration costs on unproved properties are expensed. Losses can be carried forward indefinitely, linked to the increase in the Israeli Consumer Price Index. At December 31, 2004, the Company has available net operating loss carryforwards of approximately \$1,727,000 to reduce future Israeli taxable income.

7. 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 and 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.

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 liability, which it may have, as it relates to any environmental clean up, restoration or the violation of any rules or regulations relating thereto. Liabilities for expenditures are recorded when environmental assessment and/or remediation is probable and the costs can be reasonably estimated.

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Zion Oil & Gas, Inc.

NOTES TO FINANCIAL STATEMENTS

7. COMMITMENTS AND CONTINGENCIES (CONTINUED)

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 oil and gas produced 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 as mentioned above.

The Company has initiated the establishment of a Key Employee Royalty Pool whereby a 1 1/2% overriding royalty or equivalent interest in the Joseph Project 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.

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 Joseph Project 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).

At December 31, 2004, the Company does 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.

Drilling Commitment

On December 29, 2004, the Company signed a drilling contract with Lapidoth Israel Oil Prospectors Corp., Ltd. The contract calls for a daily rate of \$14,000 to be paid by the Company as well as a \$100,000 mobilization and \$100,000 demobilization fee. Of these sums, \$60,000 relating to mobilization was paid on signing of the contract. On February 15, 2005 an additional \$40,000 relating to the demobilization fee was required and paid. On March 7, 2005, \$200,000 was deposited in a Company account managed by a trustee in respect to this contract, \$100,000 of which related to the mobilization fee which was paid to contractor on mobilization of the rig on March 20, 2005. An additional \$840,000 was deposited in the same account on April 10, 2005, to cover the daily rate of the contract for the first 60 drilling days.

Lease Commitment

The Company is obligated under an operating lease for office space through 2008. Management expects that, in the normal course of business, leases that expire will be renewed by other leases; thus it is anticipated that future minimum lease commitments will not be less than the amount shown for the year ending December 31, 2004. Rent expense for all operating leases was approximately \$36,664 and \$13,277, net of month-to-month sublease income of \$21,840 and \$7,464 for 2004 and 2003, respectively. During 2003, the Company entered into a five year lease agreement for office space in Dallas, Texas. The future minimum lease payments are as follows:

| | |
|------|---------------|
| 2005 | 49,244 |
| 2006 | 49,560 |
| 2007 | 51,138 |
| 2008 | <u>42,615</u> |

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Zion Oil & Gas, Inc.

NOTES TO FINANCIAL STATEMENTS

8. SUBSEQUENT EVENTS

Exercise of Warrants

In January 2005, warrants to purchase 358,167 shares of the Company's common stock were exercised raising a total of \$461,500. Warrants to purchase 167,334 shares of the Company's common stock were exercised to reduce debt and accounts payable totaling \$171,001.

Private Placement Offering

In January, February, and March 2005, the Company raised \$1,210,000 through the issuance of 302,500 shares of common stock and warrants to purchase 121,000 shares of the Company's common stock at \$5 per share in a private placement offering. The warrants expire December 31, 2006.