

Financial Statements of

ARSENAL ENERGY INC.

For the six months ended June 30, 2003 (unaudited)

ARSENAL ENERGY INC.

To the Shareholders:

During the second quarter, Arsenal Energy Inc. and Legend Capital Corp. successfully completed their amalgamation. I would personally like to thank Sherwood Young, former president of Legend Capital Corp., and the Legend Capital Corp. board of directors for their diligence and efforts.

Wet weather at the Kerrobert, Saskatchewan project was instrumental in hampering light oil production from Arsenal interest wells. We do not expect a return to full production until August. The operator of the Kerrobert drilling program will be using produced oil from existing wells as a frac fluid on the nine new wells. This will help reduce well costs although oil sales will be down in the short term.

Our new nine (9) well (3.375 net) drilling program was postponed until the third quarter of this year due to rig accessibility and access. However, your Company should realize production from the said new wells near the end of our fiscal third quarter.

Gross revenue for the first half of the year from oil and gas sales was \$416,086 with a cash flow from operations of \$143,312. Net earnings for the first six months was \$50,112. Oil and gas prices are expected to remain relatively high and Arsenal will continue to evaluate opportunities and, when the timing is correct, act on them.

Yours truly,
Michael S. Vandale
President
Arsenal Energy Inc

ARSENAL ENERGY INC.

Balance Sheet

	June 30 2003 (unaudited)	June 30 2002 (unaudited)
Assets		
Current Assets		
Cash and short-term deposits	\$ 4,580	\$ 311,342
Accounts receivable	53,301	14,123
Prepaid expense	<u>215,520</u>	<u>0</u>
	273,401	325,465
Capital Assets (note 3)	1,468,087	0
	<u>\$ 1,741,488</u>	<u>\$ 325,465</u>
Liabilities and Shareholders Equity		
Current Liabilities		
Accounts Payable	\$ 182,438	\$ 4,750
Bank Loan (note 4)	<u>710,000</u>	<u>0</u>
	892,438	4,750
Future site restoration	2,000	0
Shareholders equity		
Share Capital (note 5)	997,036	449,170
Retained earnings (deficit)	<u>(149,986)</u>	<u>(128,455)</u>
	847,050	320,715
	<u>\$ 1,741,488</u>	<u>\$ 325,465</u>

See accompanying notes to financial statement.

ARSENAL ENERGY INC.

Statement of Operations

	June 30 2003 (unaudited)	June 30 2002 (unaudited)
Revenue		
Oil and Gas Sales (net of royalties)	\$ 393,611	\$ 0
Interest income	0	2,456
Royalty income	<u>22,475</u>	<u>0</u>
	416,086	2,456
Expenses		
Oil and Gas Production	85,486	0
Depreciation and depletion	92,200	0
General and administrative	<u>188,288</u>	<u>81,725</u>
	365,974	81,725
Net (loss) earnings	50,112	(79,269)
Retained earnings (deficit), beginning of period	(200,098)	(49,186)
Retained earnings (deficit), end of period	<u>\$ (149,986)</u>	<u>\$ (128,455)</u>
<u>Earnings per share (note 4)</u>		
Basic	\$.01	\$ -
Diluted	<u>.01</u>	<u>-</u>

See accompanying notes to financial statements

ARSENAL ENERGY INC.

Statement of Cash Flows

	June 30 2003	June, 30 2002
	(unaudited)	(unaudited)
Cash provided by (used in):		
Operations:		
Net (loss) earnings	\$ 50,112	\$ (79,269)
Items not involving cash:		
Provision for site restoration	1,000	0
Depreciation and depletion	92,200	0
Funds from operations	143,312	(79,269)
Changes in non-cash working capital	(162,567)	(15,489)
	(19,255)	(94,758)
Financing:		
Increase in bank debt	370,000	0
Cash acquired on acquisition	253,262	0
Amalgamation costs	(40,253)	0
Investing:		
Acquisition of capital assets	562,165	0
Increase (decrease) in cash and short-term deposits		
	1,589	(94,758)
Cash and short-term deposits, beginning of period		
	2,991	406,100
Cash and short-term deposits, end of period		
	4,580	311,342
<u>Funds from operations per share</u>		
Basic	\$.02	\$ -
Diluted	.02	-

ARSENAL ENERGY INC.

Notes to Financial Statement

Six months ended June 30, 2003 (unaudited)

1. Incorporation and organization of the Company:

Arsenal Capital Inc. was incorporated under the *Business Corporations Act (Alberta)* on August 3, 2000 as a Capital Pool Company as defined in policy 2.4 of the Canadian Venture Exchange. In 2002 the “Qualifying Transaction” was completed and the name was changed to Arsenal Energy Inc. On October 18, 2002 Arsenal amalgamated with AC Global Corp. and on May 29, 2003 successfully completed a second amalgamation with Legend Capital Corp.

2. Significant accounting policies:

(a) Petroleum and natural gas properties:

The Company follows the full cost method of accounting for petroleum and natural gas properties whereby all costs of exploring for and developing the properties are capitalized by cost centre. Costs include land acquisition, drilling of productive and non-productive wells, geological and geophysical expenses and related overhead.

Capitalized costs, excluding costs related to unproven properties, are depleted using the unit-of-production method based on estimated proven reserves of petroleum and natural gas before royalties as determined by independent petroleum engineers. For purposes of the depletion calculation, natural gas reserves and production are converted to equivalent volumes of crude oil based on relative energy content.

The Company applies a “ceiling test” to capitalized costs to ensure that such costs do not exceed future net revenues from estimated production of proven reserves, using prices and costs in effect at the Company’s year end, and the costs of unproven properties less impairment. Future net revenues are undiscounted and are calculated after deducting general and administrative costs, financing costs, income taxes and site restoration and abandonment costs.

Proceeds from the sale of petroleum and natural gas interests are applied against capitalized costs with no gain or loss recognized unless such a sale would significantly alter the rate of depletion and depreciation.

(b) Interest in joint ventures:

A portion of the Company’s petroleum and natural gas exploration and development activities are conducted jointly with others and, accordingly, the financial statements reflect only the Company’s proportionate interest in such activities.

(c) Future site restoration and abandonment costs:

Site restoration and abandonment costs are provided for over the life of the estimated proven reserves on a unit-of-production basis. Costs are estimated each year by management in consultation with the Company’s engineers based on current regulations, costs, technology and industry standards. The period charge is expensed and actual site restoration and abandonment expenditures are charged to the accumulated account as incurred.

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2. Significant accounting policies (continued):

(d) Use of estimates:

The amounts recorded for depletion, depreciation and amortization of petroleum and natural gas properties and equipment and the provision for future site restoration and abandonment costs are based on estimates. The ceiling test is based on estimates of proven reserves, production rates, oil and gas prices, future costs and other relevant assumptions. These estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

(e) Per share amounts:

The Company uses the treasury-stock method to determine the dilutive effect of stock options to other dilutive instruments. Under the treasury-stock method, only “in the money” dilutive instruments impact the fully diluted calculations. In computing diluted earnings per share, no shares are added to the weighted average number of common shares outstanding for the dilutive effect of stock options as they are all anti-dilutive.

(f) Stock based compensation plan:

The Company has a stock based compensation plan, described in the notes. No compensation expense is recognized for these plans when stock options are issued to employees. Any consideration paid by employees on exercise of stock options is credited to share capital. The Company does not purchase stock or stock options from employees as part of its stock-based compensation plan.

(g) Financial instruments:.

The Company uses derivative financial instruments from time to time to hedge its exposure to fluctuations in oil and natural gas prices. Gains or losses from these activities are reported as adjustments to the related revenue or expense accounts.

(h) Income taxes:

The company follows the asset and liability method of tax allocation accounting. Temporary differences arising from the tax basis of an asset or liability and its carrying amount on the balance sheet are used to calculate future income tax liabilities or assets. Future income tax liabilities or assets are calculated using tax rates anticipated to apply in the periods that the temporary differences are expected to reverse.

3. Capital assets:

	<i>Cost</i>	<i>Accumulated depreciation</i>	<i>Net Book Value</i>
Petroleum and natural gas properties and equipment	\$ 1,569,773	\$ 112,400	\$ 1,457,373
Furniture, fixtures and equipment	12,014	1,300	10,714
	<u>\$ 1,581,787</u>	<u>\$ 113,700</u>	<u>\$ 1,468,087</u>

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4. Bank loan:

The Company has available a demand operating loan facility in the amount of \$730,000 bearing interest of bank prime rates plus 0.5% per annum and secured by a \$5,000,000 demand debenture with a first and floating charge on all assets with reductions of \$10,000 per month in availability.

5. Share capital:

(a) Authorized:

- (i) Unlimited number of common shares; and
- (ii) Unlimited number of preferred shares, issuable in series (of which none have been issued).

(b) Issued common shares:	Number of shares	Amount
Balance December 31, 2002	6,660,000	\$ 784,027
On amalgamation June 6, 2003:		
Issued to Arsenal shareholders	4,800,000	802,196
Issued to Legend shareholders	1,165,836	194,840
<u>Balance June 30, 2003</u>	<u>5,965,836</u>	<u>\$ 997,036</u>

(c) Stock options:

The Company has granted its directors and officers options to acquire 974,432 common shares at an exercise price of \$0.20 per share under a stock option plan. The options will expire five years from December 21, 2000.

6. Related party transactions:

During the six months there were no related party transactions.