Financial Statements of

Arsenal Energy Inc.

For the six months ended June 30, 2004

(unaudited)

To the Shareholders:

During the second quarter Arsenal devoted much of its energy to evaluating and financing the proposed purchase of producing oil and gas properties in North Dakota. Oil production from existing Kerrobert and Dodsland light oil properties averaged approximately 45 barrels per day for the quarter..

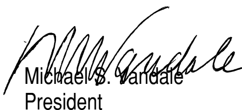
Our planned light oil and natural gas property purchase of 400 BOE/D for $6,350,000 in North Dakota, which was originally to close on July 1, 2004, has been rescheduled to close on August 31, 2004. Arsenal has deposited $350,000 at this time. To finance the acquisition your company has negotiated a $4,000,000 revolving line of credit from a bank. Arsenal engaged an agent on a short form prospectus to raise between 1,000,000 and $2,000,000 CDN at $0.60 per share with a half warrant at $1.00 per share exercisable for one calendar year. Management feels it may be prudent to do only the minimum allotment under the offering in order to prevent more dilution at a lesser share price. This decision is predicated upon the new optimistic events which have been recently presented to us. We fully expect the closing adjustments to reduce the purchase price by $1,000,000. Management will also arrange a prepayment on the oil production to raise the remaining incremental amount in order to close the purchase.

An independent third party engineering report has assigned total gross proved and probable reserves of 1,680,000 barrels of light oil, 1.3 billion cubic feet of natural gas, and 290,000 barrels of natural gas liquids to the North Dakota properties. Our purchase prices of proved oil and gas reserves under $4.00 CDN per barrel or $15,875 CDN per producing barrel per day are significantly cheaper than industry standards. The negotiated price took place when world oil prices were $15 US per barrel lower than the present market climate. The recent dramatic rise of oil prices has enhanced the positive economic impact of our acquisition. Management intends to hedge 200 barrels of oil/day shortly at approximately $41 US before prepayment over a two year period in order to fulfill terms of our banking arrangement. Arsenal will also examine the possibility of fixing the US dollar against the rising Canadian dollar in the very near future as a form of monetary protection.

Upon completion of the deal Arsenal will be examining production enhancement opportunities in North Dakota through waterflood and infill drilling programs. Management sees significant upside production potential on the properties and will be seeking methods to implement them. Two additional staff in the office will be needed in the third quarter to carry out the proposed programs.

Upon completion of the deal, Arsenal will be producing approximately 450 BOE/day. Our proved and probable gross oil and gas reserves will be approximately 2,350,000 barrels of energy (6:1 natural gas to oil conversion) with an economic life span of 15 years at $33 US per barrel. Overtures have been made to the company regarding a flow through share offering at a higher share price than market later on in the fall. Arsenal has a number of drilling prospects in inventory that may impact our future growth in a significant manner. Arsenal is examining a move to the Toronto Stock Exchange by the end of our fiscal year. This is the next step in our growth strategy.

On behalf of the Board of Directors,



Michael S. Vandale
President

Reader Advisory: This document contains forward looking statements relating to financial condition, results, reserves, development, cash flows among other matters. These forward looking statements are estimates in the best judgment of Arsenal Energy Inc. They involve a number of known and unknown risks and uncertainties including but not limited to commodity prices, drilling costs, exploration success rate, interest rate changes and environmental items that could cause actual results to differ materially from those suggested in the statements. Reader is cautioned not to place undue reliance on these forward looking statements which speak only as of the date they were made. Additionally, we do not undertake to any obligation to publicly release any revisions to these forward looking statements.

Management's Discussion and Analysis

June 30, 2004 - The following Management's Discussion and Analysis of financial results as provided by the management of Arsenal Energy Inc. ("Arsenal" or "The Company") should be read in conjunction with the unaudited interim financial statements and selected notes for the six months ended June 30, 2004 and 2003. This commentary is based on information available to June 30, 2004.

BOE's may be misleading, particularly if used in isolation. A boe conversion ratio of six thousand cubic feet per barrel (6mcf/bbl) of natural gas to barrels of oil equivalence is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

Management's Discussion and Analysis contains the term cash flow from operations, which should not be considered an alternative to, or more meaningful than cash flow from operations as determined in accordance with Canadian generally accepted accounting principals ("GAAP") as an indicator of the Company's performance. The Company presents cash flow from operations per share whereby per share amounts are calculated consistent with the calculation of earnings per share. The consolidated statements of cash flows in the unaudited interim financial statements present the reconciliation between net earnings and cash flow from operations.

NET EARNINGS AND CASH FLOW FROM OPERATIONS

Arsenal generated cash flow from operations of $6,639 for the six months ended June 30, 2004, down from $145,312 produced in the same period of 2003. The decrease is attributed to a 23% production decrease and a 27% increase in general and administrative costs.

For the six months ended June 30, 2004, the net loss was $121,523, compared to net earnings of $45,879 for the same period in 2003. Net earnings for 2003 were restated to reflect the adoption of CICA Handbook Section 3110 "Asset Retirement Obligations" (resulting in a net earnings decrease of $4,233).

SALES VOLUMES

Sales volumes for the first six months of 2004 averaged 45 boe/d, down from the 54 boe/d reported for the same period in 2003.

Commodity Prices

For the six months ending June 30, 2004, Arsenal received an average price for crude oil and liquids of $47.17/bbl, compared to $46.02/bbl received during the same period in 2003.

Revenue

Revenue for the six months ended June 30, 2004 was $333,749, 22% lower than the same period in 2003. The reduction in sales was a result of Viking production levelling off after initial high flow rates. This is typical of wells drilled in the Viking formation in Saskatchewan.

Royalties

For the six months ending June 30, 2004, total royalties were $62,037 compared with $80,048 in the same period in 2003.

Operating Expenses

For the six months ended June 30, 2004, operating costs totaled $87,696, compared to $85,486 in the same quarter of 2003. Operating expenses averaged $11.36/boe for the second quarter of 2004, up $3.05/boe, compared to the same period in 2003.

Operating Netbacks

Operating netbacks for Arsenal in the second quarter of 2004 were $27.84/boe and $29.93/boe in the second quarter of 2003.

General and Administrative

Gross general and administrative costs during the second quarter of 2004 were $239,416 compared to $188,288 in 2003. This increase in the amount of general and administrative costs represents an increase in administrative focus on exploration projects, acquisition opportunities and financing. No general and administrative costs were capitalized in any reporting period.

Capital Expenditures

Capital expenditures in the six months ending June 30, 2004 were $549,069, compared to $562,165 in 2003. Arsenal drilled 4 (1.0 net) exploration wells in the first six months of 2004. In the second quarter of 2003 capital expenditures related to the completion and equipping of 10 (3.75 net) wells drilled in the fourth quarter of 2002.

At June 30, 2004, the Company had approximately 54,640 gross (13,660 net) undeveloped acres of land in Saskatchewan. During the first quarter of 2004, the Company completed the first phase of a large area farm-in arrangement in the Bengough, Saskatchewan area with the drilling of the four wells.

Depletion, Depreciation and Accretion Costs

Depletion, depreciation and accretion (site restoration) expense for the six months ended June 30, 2004 totaled $115,443 compared to $96,433 expensed in the second quarter of 2003. The depletion and depreciation rate for the second quarter of 2004 averaged $14.95/boe, compared to $9.87/boe in the second quarter of 2003. Depletion, depreciation and accretion (site restoration) for the second quarter of 2003 was related to reflect the adoption of CICA Handbook Section 3110 ìAsset Retirement Obligationsî (resulting in a net expense increase of $4,233).

Income Taxes

In the second quarter of 2004, Arsenal recorded a future income tax provision of $396,088 relating to expenditure commitments for proceeds of $1,000,000 from flow-through share placement received in the period. Future income tax expense for the second quarter of 2003 was restated to reflect the adoption of CICA Handbook Section 3110 “Asset Retirement Obligations” (resulting in no material change in the original income tax position).

Liquidity and Capital Resources

Arsenal had a working capital of $170,097 and an undrawn revolving credit facility with an authorized amount of $610,000.

Arsenal is committed , by the end of 2004, to incur $1,400,000 of income tax attributes associated with oil and gas exploration and development activities pursuant to a flow-through common share financing in December 2003. By June 30, 2004 the Company had incurred $532,000 of qualifying expenditures, with $868,000 remaining to be incurred by December 31, 2004.

Based on the current forecasts of operations for 2004, the Company will continue to fund itís requirements with cash flow from operations, non-core divestitures, equity financing and forecasted credit facilities.

In May 2004, Arsenal finalized a second flow-through share private placement and incurred a further commitment for $1,000,000 of qualifying expenditures in 2005.

Business Prospects and 2004 Outlook

Arsenal Energy is optimistic about its future prospects. The Company expects to deliver future growth through development of its core assets, new exploration on the Company’s inventory of geological prospects and acquisitions of producing properties. Currently, the Company’s producing properties are located in west central Saskatchewan. During the remainder of 2004, the Company will continue to focus its exploration efforts for natural gas and economically viable crude oil.

The Company anticipates that 2004 average production from existing producing properties will be between 40 and 50 boe/d. Market supply and demand, combined with political instability in the Middle East countries should translate into strong prices for crude oil and natural gas during 2004.

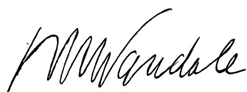
Arsenal intends to resume exploration in Bengough, Saskatchewan properties in Q4. Activity has been impacted by a dispute between the other two parties.

Arsenal has signed a Purchase and Sale Agreement with a major company to acquire producing oil and gas properties in North Dakota with a closing date of August 31, 2004. Current production is approximately 404 boe/day. The transaction which will positively impact cash flow has a total purchase price of $6,350,000, less adjustment for net revenue for the period March 1, 2004 to August 31, 2004. The acquisition will be financed by equity offerings, existing cash, divestiture of non-core properties and a bank credit line. Currently, Arsenal has obtained a commitment letter for a production loan for up to $4,000000 and has secured a hedging agreement for 200 boed including some monetization above a base price .The company is progressing with the necessary equity financing. Arsenal views this acquisition as a significant step forward given the attractive price and development opportunities on a stable output base, especially with the current oil and gas pricing outlook.

Notice to Shareholders

The accompanying unaudited interim financial statements of Arsenal Energy Inc. have been prepared by management and approved by the audit committee and Board of Directors of the Corporation. These statements have not been reviewed by the Corporation's external auditors.

Dated June 30, 2004



President and Chief Financial Officer

Arsenal Energy Inc.

Balance Sheet

	June 30 2004	December 31 2003
	(unaudited)	(restated) (unaudited)
Assets		
Current Assets		
Cash and short-term deposits	$ 152,928	$ 743,580
Accounts receivable (note 12)	160,018	93,439
	312,946	837,019
Capital Assets (note 4)	2,476,407	2,052,837
Prepaid Expense (note 9)	250,000	0
Shareholder Loan (note 13)	325,000	0
	$ 3,364,353	$ 2,889,856
Liabilities and Shareholders Equity		
Current Liabilities		
Accounts Payable	$ 142,849	$ 535,514
Other Liabilities		
Asset retirement obligation (note 7)	107,445	106,582
Future income tax	579,848	183,760
	687,293	290,342
Shareholders equity		
Share Capital (note 6)	2,748,547	2,163,533
Contributed surplus (note 6(e))	66,710	59,990
Retained earnings (deficit)	(281,046)	(159,523)
	2,534,211	2,064,000
	$ 3,364,353	$ 2,889,856

See accompanying notes to financial statement.

Arsenal Energy Inc.

Statement of Operations and Deficit

	Six months ended June 30		Three months ended June 30	
	2004	2003	2004	2003
	(unaudited)	(restated) (unaudited)	(unaudited)	(restated) (unaudited)
Revenue				
Oil and Gas Sales (net of royalties)	$ 303,076	$ 393,611	$ 130,774	$ 120,597
Royalty income	30,675	22,475	7,935	11,451
	333,751	416,086	138,709	132,048
Expenses				
Oil and Gas Production	87,696	85,486	23,749	36,000
Depreciation, depletion and accretion	115,443	96,433	43,480	31,034
General and administrative	252,135	188,288	150,175	108,871
	455,274	370,207	217,404	175,905
Net (loss) earnings before tax	(121,523)	45,879	(78,695)	(43,857)
Provision for income taxes			(1,430)	0
Income (loss) for the period	(121,523)	45,879	(77,265)	(43,857)
Retained earnings (deficit), beginning of period	(159,523)	(200,098)	(203,781)	(110,362)
Retained earnings (deficit), end of period	$ (281,046)	$ (154,219)	$ (281,046)	$ (154,219)
Earnings per share (note 4)				
Basic	$ (.01)	$ .01	$ (.001)	$ (.001)
Diluted	(.01)	.01	(.001)	(.001)

See accompanying notes to financial statements

Arsenal Energy Inc.

Statement of Cash Flows

	Six months ended June 30		Three months ended June 30	
	2004	2003	2004	2003
	(unaudited)	(restated) (unaudited)	(unaudited)	(restated) (unaudited)
Cash provided by (used in):				
Operations:				
Net (loss) earnings	$ (121,523)	$ 45,879	$ (77,265)	$ (43,857)
Items not involving cash:				
Stock based compensation (note 3d)	12,719			
Provision for income tax			(1,430)	0
Depreciation, depletion and accretion	115,443	96,433	43,480	31,034
Funds from operations	6,639	142,312	(35,215)	(12,823)
Changes in non-cash working capital	(709,244)	(161,567)	(9,140)	49,607
	(702,605)	(19,255)	(44,355)	36,784
Financing:				
Increase in bank debt	0	370,000	0	(40,000)
Cash acquired on Legend Amalgamation	0	253,262	0	253,262
Amalgamation costs	0	(40,253)	0	(40,253)
Issuance of shares	675,000	0	0	0
Share issue costs	(24,896)	0	(17,121)	0
	650,104	583,009	(17,121)	173,009
Investing:				
Asset retirement cost	(10,918)	0	3,549	(1,034)
Prepaid expense			250,000	0
Acquisition of capital assets	549,069	562,165	43,769	208,867
	538,151	562,165	297,318	207,833
Increase (decrease) in cash and short-term deposits	(590,652)	1,589	(358,794)	1,960
Cash and short-term deposits, beginning of period	743,580	2,991	511,722	2,620
Cash and short-term deposits, end of period	152,928	4,580	152,928	4,580

Arsenal Energy Inc.

Notes to Financial Statements

March 31, 2004

1. Incorporation and organization of the Company:

Arsenal Capital Inc. was incorporated under the *Business Corporations Act* (Alberta). During 2002, the Company completed its qualifying transaction and changed its name to Arsenal Energy Inc.

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 petroleum and natural gas and related reserves are capitalized by cost centre. Such costs include land acquisition costs, cost of drilling both productive and non-productive wells, and geological and geophysical expenses and related overhead.

Capitalized costs, excluding costs relating 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.

Depreciation of equipment, furniture and leasehold improvements is provided for on a declining balance at a rate of 20% per year.

(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) 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 proved reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, 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.

(d) Per share amounts:

Basic per share amounts are calculated using the weighted average number of shares outstanding during the year. Weighted average number of shares is determined by relating the portion of time within the reporting period that common shares have been outstanding to the total time in that period.

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 dilutive instruments where the market price exceeds the exercise price impact the diluted calculations.

(e) 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 when a gain or loss is realized.

(f) Income taxes:

The Company follows the asset and liability method of tax accounting. Temporary differences arising from the difference between 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. Future tax assets are recorded only to the extent it is more likely than not these assets will be realized.

(g) Flow-through shares:

Flow-through shares are issued at a fixed price and the proceeds are used to fund qualifying exploration and development expenditures within a defined period. The qualifying expenditure deductions funded by flow-through arrangements are renounced to investors in accordance with Canadian tax legislation. To recognize the foregone tax benefits of flow-through shares, share capital is reduced and a future income tax liability is recorded for the estimated future tax cost of the renounced expenditures, when the expenditures are renounced.

3. Changes in accounting policies:

(a) Asset retirement obligations:

Effective January 1, 2004, the Company adopted the new Canadian accounting standard for asset retirement obligations. The new standard requires the Company to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and depleted and depreciated using a unit of production method over estimated gross proved reserves. Subsequent to the initial measurement of the asset retirement obligations, the obligations are adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. The effect of adoption of the new standard on the financial statements is disclosed in note 7.

(b) Full cost ceiling test:

Effective January 1, 2004, the Company adopted the new Canadian accounting guideline for the full cost method of accounting for oil and gas activities. The new guideline requires a detail impairment calculation when events or circumstances indicate a potential impairment of the carrying amount of oil and gas assets may have occurred, but at least annually.

An impairment loss is recognized when the carrying amount of a cost centre is not recoverable and exceeds its fair value. The carrying amount is assessed to be recoverable when the sum of the undiscounted cash flows expected from proved reserves plus the cost of unproved interests, net of impairments, exceeds the carrying amount of the cost centre. When the carrying amount is assessed not to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted cash flows from proved and probable reserves plus the cost of unproved interests, net of impairments, of the cost centre. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate. Adoption of the new guideline had no effect on the Company's financial statements. The future prices used in the initial adoption ceiling test are disclosed in note 4.

Prior to January 1, 2004, an impairment loss was recognized when the carrying amount of a cost centre exceeded its recoverable amount. The recoverable amount was the sum of the undiscounted cash flows expected from the production of proved reserves plus the lower of cost or market of unproved interests less estimated future costs for administration, financing and site restoration. The cash flows were estimated using period prices and costs.

(c) Hedging relationships:

Effective January 1, 2004, the Company adopted the new Canadian accounting guideline relating to hedging relationships which require the identification, designation and documentation of each hedging relationship as well as an assessment of the effectiveness of the hedging relationship. The guideline does not specify how hedge accounting is applied, and accordingly, the Company's derivative financial instrument accounting policy in the 2003 annual consolidated financial statements remains unchanged. Adoption of the new guideline had no effect on the Company's financial statements.

(d) Stock-based compensation:

Effective January 1, 2004, the Company retroactivity adopted the revised Canadian accounting standard for stock-based compensation and other stock-based payments without restatement of prior periods. Under the fair value method, compensation cost attributable to all stock options granted to employees and directors is measured at fair value at the grant date and expensed over the vesting period with a corresponding increase to contributed surplus. Upon the exercise of the option, consideration received together with the amount previously recognized in the contributed surplus is recorded as an increase to share capital. The effect of adoption of the revised standard on the financial statements is disclosed in note 6(e).

Prior to January 1, 2004, no compensation cost was recorded for stock options granted to employees and directors. The company previously disclosed the pro forma effect of accounting for these awards under the fair value based method.

4. Property, plant and equipment:

	Cost	Accumulated depreciation	Net book value
Petroleum and natural gas properties and equipment	$ 2,889,786	$ 440,178	$ 2,449,608
Other equipment	35,292	8,493	26,799
	$ 2,925,078	$ 448,671	$ 2,476,407

Adoption of the new ceiling cost guideline, as outlined in note 3(b), had no effect on the Company's financial statements. The future commodity prices used in the ceiling test prepared on initial adoption were based January 1, 2004 commodity price forecasts of our independent reserve engineers adjusted for differential specific to the Company reserves. The following table summarizes the future benchmark prices and Company used in the ceiling test:

	WTI Oil ($US/bbl)	Foreign Exchange Rate	WTI Oil ($Cdn/bbl)	Company Price Oil	AECO Gas ($Cdn/mcf)	Company Price Gas
2004	$29.00	0.75	$38.67	$29.38	$5.50	$5.65
2005	$26.50	0.75	$35.33	$28.10	$5.19	$5.30
2006	$25.50	0.75	$34.00	$27.35	$4.87	$4.95
2007	$25.00	0.75	$33.33	$26.45	$4.68	$4.75
2008	$25.00	0.75	$33.33	$26.23	$4.53	$4.60
Annual escalation thereafter	1.50%		1.50%	1.50%	1.50%	1.50%

5. Bank loan and promissory notes:

The Company has available a demand operating loan, undrawn as of June 30, in the amount of $610,000 bearing interest at the bank prime rate plus 0.5% per annum and is secured by a $5,000,000 demand debenture with a first and floating charge and a general security agreement on all assets.

6. 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, 2003	8,741,875	$ 2,163,533
Issued on acquisition of Orange Exploration	1,850,000	—
Share issue costs	—	(24,896)
Tax effect of share issue costs	—	10,111
Private placement of common shares	1,000,000	1,000,000
Tax effect of flow-through shares	—	(406,200)
Balance, June 30, 2004	11,591,875	$ 2,742.548

(c) Flow through shares:

In the six months ending June 20, 2004 the Company executed subscriptions for 1,000,000 flow-through shares for proceeds of $1,000,000. A future tax adjustment relating to the flow-through shares of $406,200 has been recorded to future tax liability. The Company has a commitment to expend $1,000,000 of income tax attributes associated with oil and gas exploration and development activities by December 31, 2005.

(d) Stock options:

The Corporation has a fixed stock option plan in which the Company may grant up to 1,950,000 options to its employees, officers, directors and consultants of the Company increased from 1,200,000 at the May AGM. In the six months ending June 30, 2004 the Company granted a total of 300,000 options to the three new directors elected at the AGM. These options expire five years from their grant date and have an exercise price of $0.50 per share. The options vested immediately.

(e) Stock-based compensation:

The effect of the change in accounting policy as outlined in note 3(d) has been recorded retroactively without restatement of prior periods. At January 1, 2004, the effect of the change resulted in an increase to contributed surplus and an offsetting decrease to retained earnings of $43,290.

7. Asset retirement obligations:

The effect of the change in accounting policy as outline in note 3(a) has been recorded retroactively with restatement of prior periods. The effect of the adoption on the balance sheet and statement of earnings is presented below as increases (decreases):

Balance Sheet	At December 31	
	2003	2002
Asset retirement cost, included in property and equipment	90,307	67,273
Asset retirement obligations	106,582	68,840
Future income tax liability	1,760	0
Accumulated future abandonment and site restoration	0	0
Retained earnings	(18,754)	(1,980)

Statement of Earnings	Six month Period ended June 30, 2004	Year ended December 31, 2003
Accretion expense	$ 2,262	$ 14,708
Future abandonment and site restoration liability	0	(8,172)
Future income tax expense	0	1,760
Depletion on asset retirement costs	1,971	10,458
Net Earnings	$ (4,233)	$ (18,754)
Net earnings per share:		
Basic	$ 0.0	$ (0.004)
Diluted	$ 0.0	$ (0.004)

The Company's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The company estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations is approximately $142,750 which will be incurred between 2008 to 2018. The majority of the costs will be incurred between 2010 and 2012. A credit-adjusted risk free rate of 6.5 percent was used to calculate the fair value of the asset retirement obligations.

A reconciliation of the asset retirement obligations is provided below:

	Six month period ended June 30		Year ended Dec. 31,
	2004	2003	2003
Balance, beginning of period	$106,582	$ 68,840	$ 68,840
Accretion expense	863	1,404	14,708
Liabilities incurred		0	23,034
Liabilities settled	0	0	0
Revision in estimated cash flow	0	0	0
Balance, end of period	$107,445	$ 70,244	$106,582

8. Business Acquisition:

On March 24, 2004 Arsenal completed the acquisition of Orange Exploration Inc. As a result of the acquisition, Arsenal issued 1,850,000 common shares of Arsenal at a deemed price of $0.50 per common share and an aggregate of 1,200,000 share purchase warrants for the issued and outstanding Orange shares. Each warrant is exercisable into one (1) common share of Arsenal at an exercise price of $0.53 per share on or before March 24, 2005.

9. Prepaid expense:

Prepaid expense is a non-refundable deposit in the amount of $250,000 paid to secure the purchase and sale agreement for the North Dakota acquisition. (see note 11)

10. General and administrative expense:

Major components of general and administrative expense incurred in the six months ending June 30, 2004:

Accounting and audit fees	$ 28,525
Business development	14,630
Consultants	75,000
Engineering reports	10,635
Legal fees	20,479
Office expense	25,809
Shareholder reports and listing fees	20,551
Travel and subsistence	13,320

11. Subsequent events

(a) The Company has entered into a letter agreement to acquire oil and gas properties in the United States for a total consideration of $6,350,000. The closing date of the acquisition is August 31, 2004.

The obligations of Arsenal to complete the acquisition are subject to certain conditions, including but not limited to: (i) the parties entering into a formal purchase and sale agreement on or before May 21, 2004 (ii) all necessary regulatory and third party consents, orders, approvals and authorizations as may be required in respect of the proposed acquisition shall have been received; (iii) Arsenal shall have been satisfied with its due diligence review of the North Dakota properties; and (iv) Arsenal shall have obtained the approval of its lending institutions for the financing of the purchase of the North Dakota properties. The effective date and closing date were subsequently revised to March 1 and August 31, 2004 respectively. A management fee of $100,000 was paid in consideration of the revision and in light of positive oil price movement. See the Business Outlook section of the MD+A for further disclosure regarding the acquisition.

12. Accounts Receivable:

(a) These include $80,000 deposited on a potential property acquisition. Arsenal expects to recover this amount.

13. Shareholder loan

(a) This loan is a demand promissory note from M Vandale secured against pledge of securities acquired in the Flow Through offer completed by the company in May.

BOARD OF DIRECTORS

Michael Vandale, President
Calgary, Alberta

Greg Belzberg
Los Angeles, California

Alain Gaucher
Saskatoon, Saskatchewan

William Hews
Calgary, Alberta

Neil Mackay
Saskatoon, Saskatchewan

Errol Stewart
Calgary, Alberta

Curtis Stewart
Calgary, Alberta

LEGAL
Borden Ladner Gervais LLP

ACCOUNTING
KPMG LLP

ENGINEERING
Gilbert Lausten Jung

1820, 330 5th Avenue S.W.
Calgary, Alberta Canada T2P 0L4
Telephone: (403) 262-4854 Facsimile: (403) 265-6877
E-mail: info@aren.ca

ARSENAL ENERGY INC.

QUARTERLY REPORT
SIX MONTHS ENDED JUNE 30, 2004

SCHEDULE B: SUPPLEMENTARY INFORMATION

1. Analysis of Expenses and deferred costs

General and Administrative:	Six Months Ended June 30, 2004
Accounting and Audit	$ 29,410
Bank Interest and Service Charges	1,058
Business Development	16,130
Consultants	75,000
Engineering and GeoCarta	15,135
Insurance	6,522
Legal Fees	20,479
Listing Fees	9,450
Miscellaneous	5,622
Office Expense	12,917
Office Supplies	4,062
Postage and Courier	1,098
Salaries	4,168
Shareholder Reports and Transfer Agent Fees	11,101
Stock Based Compensation	12,719
Taxes and Licences	2,608
Telephone	9,836
Travel	14,820
	$ 252,135

2. Related party transactions

There were no related party transactions.

3. Directors and officers of the corporation

Michael Vandale	Director, President and Chief Executive Officer
Greg Belzberg	Director
Alain Gaucher	Director
William Hews	Director
Neil MacKay	Director
Curtis Stewart	Director
Errol Stewart	Director