

Financial Statements of

**ARSENAL ENERGY INC.**

**For the quarter ended March 31, 2004 (unaudited)**

May 28, 2004

To the shareholders,

The focus of the Company in the first quarter was to strengthen the balance sheet and acquire larger oil and gas producing properties. With this goal in mind, Arsenal spent significant time and effort identifying an acquisition that met certain parameters. Management was keen to purchase an operated working interest percentage property with the opportunity to increase production through drilling, water flooding and other optimization processes.

Our potential North Dakota acquisition carries the necessary characteristics to fulfill our plan. We believe the purchase prices are favourable and there exists ample scope for further development coupled with production enhancement. Management wishes to close this purchase on July 1, 2004 through a combination of existing cash, a share issuance through a major brokerage firm and bank credit lines. The planned acquisition of 400 BOE/d in North Dakota will have a significant impact on the growth of Arsenal.

Arsenal maintains an inventory of drilling locations on its lands. Drilling of the said locations will take place in the third and fourth quarters in order to meet our flow-through obligation incurred during this fiscal year.

Your company drilled four wells during the quarter on its natural gas exploration project in southern Saskatchewan. All of the wells were cased and are now being completed. Poor winter weather conditions hampered our efforts in this area. However, the arrival of spring will enable us to complete our plans. We will look closely at our results and determine our strategy accordingly.

Management feels our proposed purchase in North Dakota will be a positive step to ensure positive growth.

On behalf of the Board of Directors,

(signed) "Michael S. Vandale"  
Michael S. Vandale  
President

### ***Forward Looking Information***

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.

## **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 Corporations external auditors.

Dated May 28, 2004

(Signed) "Michael S. Vandale"  
President and Chief Executive Officer

## ARSENAL ENERGY INC.

### Balance Sheet

	March 31 2004 (unaudited)	December 31 2003 (restated) (unaudited)
<b>Assets</b>		
Current Assets		
Cash and short-term deposits	\$ 511,722	\$ 743,580
Accounts receivable	<u>181,214</u>	<u>93,439</u>
	692,936	837,019
Capital Assets (note 4)	2,476,118	2,052,837
	<u>\$ 3,169,054</u>	<u>\$ 2,889,856</u>
<b>Liabilities and Shareholders Equity</b>		
Current Liabilities		
Accounts Payable	\$ 173,185	\$ 535,514
Other Liabilities		
Asset retirement obligation (note 7)	123,713	106,582
Future income tax	<u>456,215</u>	<u>183,760</u>
	579,928	290,342
Shareholders equity		
Share Capital (note 6)	2,559,732	2,163,533
Contributed surplus (note 6(e))	59,990	59,990
Retained earnings (deficit)	<u>(203,781)</u>	<u>(159,523)</u>
	2,415,941	2,064,000
	<u>\$ 3,169,054</u>	<u>\$ 2,889,856</u>

See accompanying notes to financial statement.

**ARSENAL ENERGY INC.**

## Statement of Operations and Deficit

	March 31 2004 (unaudited)	March 31 2003 (restated) (unaudited)
Revenue		
Oil and Gas Sales (net of royalties)	\$ 172,302	\$ 273,014
Royalty income	<u>22,740</u>	<u>11,024</u>
	195,042	284,038
Expenses		
Oil and Gas Production	63,947	49,486
Depreciation, depletion and accretion	71,963	65,399
General and administrative	<u>101,960</u>	<u>79,417</u>
	237,870	194,302
Net (loss) earnings before tax	(42,828)	89,736
Provision for income taxes	1,430	0
Income (loss) for the period	(44,258)	89,736
Retained earnings (deficit), beginning of period	(159,523)	(202,078)
Retained earnings (deficit), end of period	<u>\$ (203,781)</u>	<u>\$ (112,342)</u>
<u>Earnings per share (note 4)</u>		
Basic	\$ (.003)	\$ .015
Diluted	<u>(.003)</u>	<u>.014</u>

See accompanying notes to financial statements

## ARSENAL ENERGY INC.

### Statement of Cash Flows

	March 31, 2004 (unaudited)	March 31, 2003 (restated) (unaudited)
Cash provided by (used in):		
Operations:		
Net (loss) earnings	\$ (44,258)	\$ 89,736
Items not involving cash:		
Provision for income taxes	1,430	0
Depreciation, depletion and accretion	71,963	65,399
Funds from operations	29,135	155,135
Changes in non-cash working capital	(348,810)	(212,174)
	(319,675)	(57,039)
Financing:		
Increase in bank debt	0	410,000
Issuance of shares	675,000	0
Share issue costs	(7,775)	0
	667,225	410,000
Investing:		
Asset retirement cost	10,988	0
Acquisition of capital assets	568,420	353,332
	579,408	353,332
Increase (decrease) in cash and short-term deposits	(231,858)	(371)
Cash and short-term deposits, beginning of period	743,580	2,991
Cash and short-term deposits, end of period	511,722	2,620

# ARSENAL ENERGY INC.

Notes to Financial Statements

March 31, 2004

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## 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.

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Notes to Financial Statements, Page 2

March 31, 2004

## 2. Significant accounting policies (continued):

### (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.

# ARSENAL ENERGY INC.

Notes to Financial Statements, Page 3

March 31, 2004

## 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.

# ARSENAL ENERGY INC.

Notes to Financial Statements, Page 4

March 31, 2004

## 3. Changes in accounting policy (continued):

### (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 retroactively 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	\$ 2,841,689	\$ 392,511	\$ 2,449,178
Other equipment	35,292	8,352	26,940
	<u>\$ 2,876,981</u>	<u>\$ 400,863</u>	<u>\$ 2,476,118</u>

# ARSENAL ENERGY INC.

Notes to Financial Statements, Page 5

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## 4. Property and equipment (continued):

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 in the amount of \$630,000 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	8,740,836	\$ 2,163,533
Issued on acquisition of Orange Exploration	1,850,000	--
Share issue costs	--	(7,776)
Tax effect of share issue costs	--	3,160
Private placement of common shares	675,000	675,000
Tax effect of flow-through shares	--	(274,185)
Balance, March 31, 2004	11,265,836	\$ 2,559,732

# ARSENAL ENERGY INC.

Notes to Financial Statements, Page 6

March 31, 2004

## 6. Share capital (continued):

### (c) Flow through shares:

In March 2004 the Company executed subscriptions for 675,000 flow-through shares for proceeds of \$675,000 (note 8). A future tax adjustment relating to the flow-through shares of \$274,185 has been recorded to future tax liability (note 6(b)). The Company has a commitment to expend \$675,000 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 1,200,000 options to its employees, officers, directors and consultants of the Company. During 2003 the Company granted 974,432 options to officers and directors. The options expire five years from their grant date and have an exercise price of \$0.20 per share. The options vested immediately. The weighted average contractual life (years) of the options outstanding at December 31, 2003 was 3.65.

### (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):

<u>Balance Sheet</u>	<u>At December 31</u>	
	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
<u>Retained earnings</u>	(18,754)	(1,980)

# ARSENAL ENERGY INC.

Notes to Financial Statements, Page 7

March 31, 2004

## 7. Asset retirement obligations (continued):

ended	Three month Period ended	
	March 31, 2004	December 31, 2003
Statement of Earnings		
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	1,937	10,458
Net Earnings	\$ (4,199)	\$ (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:

	Three-month period ended March 31		Year ended Dec-31 2003
	2004	2003	
Balance, beginning of period	\$106,582	\$ 68,840	\$ 68,840
Accretion expense	6,143	2,262	14,708
Liabilities incurred	10,988	0	23,034
Liabilities settled	0	0	0
Revision in estimated cash flow	0	0	0
Balance, end of period	\$123,713	\$ 71,102	\$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.

# ARSENAL ENERGY INC.

Notes to Financial Statements, Page 8

March 31, 2004

## 9. Subsequent events:

- (a) In May, 2004 the Company completed the private placement financing of 1,000,000 flow-through common shares at \$1.00 for anticipated gross proceeds of \$1,000,000 announced in March, 2004 with the execution of a final subscription for 325,000 flow-through common shares with gross proceeds of \$325,000.
- (b) The Company has entered into a letter agreement to acquire oil and gas properties in the United States for a total consideration of \$6.25 million.

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.