

Consolidated Financial Statements of

**ARSENAL ENERGY INC.**

Years ended December 31, 2008 and 2007

## MANAGEMENT'S REPORT

Management, in accordance with Canadian generally accepted accounting principles, has prepared the accompanying consolidated financial statements of Arsenal Energy Inc. (the "Company"). Financial and operating information presented throughout this report is consistent with that shown in the consolidated financial statements.

Management is responsible for the integrity of the financial information. Internal control systems are designed and maintained to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce reliable accounting records for financial reporting purposes.

KPMG LLP was appointed by the Company's shareholders to conduct an audit of the consolidated financial statements so as to express an opinion on the consolidated financial statements. Their examination included such test and procedures, as they considered necessary, to provide reasonable assurance that the financial statements are presented fairly in accordance with Canadian generally accepted accounting principles.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises this responsibility through the Audit Committee, with assistance from the Reserve Committee regarding the annual evaluation of our petroleum and natural gas reserves. The Audit Committee meets regularly with management and the independent auditors to ensure that management's responsibilities are properly discharged, to review the consolidated financial statements and recommend that the consolidated financial statements be presented to the Board of Directors for approval. The Audit Committee also considers the independence of the external auditors and reviews their fees. The external auditors have access to the Audit Committee without the presence of management.

"signed"

Tony van Winkoop

President and Chief Executive Officer

"signed"

William Hews

Chairman of the Audit Committee

March 26, 2009

## **AUDITORS' REPORT TO THE SHAREHOLDERS**

We have audited the consolidated balance sheets of Arsenal Energy Inc. as at December 31, 2008 and 2007 and the consolidated statements of operations, comprehensive income and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) "KPMG LLP"

Chartered Accountants  
Calgary, Canada  
March 26, 2009

# ARSENAL ENERGY INC.

## Consolidated Balance Sheets

As at December 31

	2008	2007
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 825,223	\$ 1,380,569
Accounts receivable	5,850,369	3,760,573
Prepaid expenses and deposits	556,804	28,711
Risk management contracts (note 16)	6,696,175	-
	13,928,571	5,169,853
Risk management contracts (note 16)	2,349,629	-
Reclamation bonds (note 9)	213,272	173,577
Property, plant and equipment (note 7)	127,232,156	61,134,541
	\$143,723,628	\$ 66,477,971
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 10,246,399	\$ 10,510,147
Revolving demand loan (note 10)	42,002,004	12,051,466
Convertible debentures (note 12)	3,463,089	-
Future income taxes (note 11)	2,202,600	-
	57,914,092	22,561,613
Convertible debentures (note 12)	-	3,340,040
Asset retirement obligations (note 13)	14,498,062	3,697,721
Future income taxes (note 11)	10,605,500	3,621,900
	83,017,654	33,221,274
Shareholders' equity:		
Common shares (note 14)	93,515,925	81,676,603
Contributed surplus (note 15(b))	4,451,743	3,430,965
Common share conversion rights (note 12)	370,000	370,000
Deficit	(37,631,694)	(52,220,871)
	60,705,797	33,256,697
	\$143,723,628	\$ 66,477,971

Future operations (note 2)  
Segmented information (note 19)  
Commitments and contingencies (note 20)  
Subsequent events (note 21)

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board:

"signed"  
William Hews  
Director

"signed"  
R. Neil MacKay  
Director

# ARSENAL ENERGY INC.

## Consolidated Statements of Operations, Comprehensive Income and Deficit

Years ended December 31

	2008	2007
Revenue:		
Oil and gas	\$ 54,479,525	\$ 31,873,269
Realized gain on commodity contracts (note 16)	7,424,828	—
Unrealized gain on commodity contracts (note 16)	9,045,804	—
Royalties	(10,892,206)	(7,096,807)
Other income	7,480	80,733
	60,065,431	24,857,195
Expenses:		
Operating	15,606,576	13,897,532
General and administrative	4,583,573	4,108,498
Finance charges (recovery) (note 14(c))	(693,764)	2,941,047
Other expenses	438,056	—
Interest on convertible debentures	278,400	278,400
Foreign exchange gain	(412,220)	(613,059)
Convertible debenture accretion	123,049	76,567
Depletion, depreciation and accretion	18,477,726	16,756,827
Property, plant and equipment impairment (note 7)	495,650	12,465,675
Goodwill impairment (note 7)	—	4,791,561
Stock-based compensation (note 15(a))	824,263	704,811
	39,721,309	55,407,859
Income (loss) before income taxes	20,344,122	(30,550,664)
Income taxes (note 11):		
Current income tax expense (recovery)	(258,981)	272,262
Future income tax expense (reduction)	6,013,926	(7,443,926)
	5,754,945	(7,171,664)
Net income (loss) and comprehensive income (loss) for the year	14,589,117	(23,379,000)
Deficit, beginning of year	(52,220,871)	(28,841,871)
Deficit, end of year	\$ (37,631,694)	\$(52,220,871)
Income (loss) per share-basic and diluted (note 14(e))	\$ 0.16	\$ (0.31)

See accompanying notes to consolidated financial statements.

# ARSENAL ENERGY INC.

## Consolidated Statements of Cash Flows

Years ended December 31

	2008	2007
Cash provided by (used in):		
Operating:		
Net income (loss) for the year	\$ 14,589,177	\$ (23,379,000)
Items not affecting cash:		
Depletion, depreciation and accretion	18,477,726	16,756,827
Property, plant and equipment impairment	495,650	12,465,675
Goodwill impairment	-	4,791,561
Current income taxes	-	(383,000)
Future income tax (reduction)	6,013,926	(7,443,926)
Convertible debenture accretion	123,049	76,567
Stock-based compensation	824,263	704,811
Unrealized foreign exchange gain	(412,220)	(613,059)
Unrealized commodity contract gain	(9,045,804)	-
Non-cash general and administrative	225,000	-
Asset retirement obligations settled	(525,475)	(321,190)
	30,765,292	2,655,266
Net change in non-cash working capital (note 18)	(745,930)	9,438,366
	30,019,362	12,093,632
Financing:		
Issue of shares for cash	4,787,059	4,174,240
Repurchase of shares	(31,200)	-
Issue of shares for cash on exercise of stock options	90,217	14,667
Share issue expenses	(392,062)	(443,855)
Revolving demand loan	18,909,565	(10,126,007)
Net change in non-cash working capital (note 18)	(24,632)	55,000
	23,338,947	(6,325,955)
Investing:		
Additions to property, plant and equipment	(21,336,860)	(20,823,716)
Acquisition of GEOCAN (note 5)	(30,420,000)	-
Proceeds on disposition	2,863,999	15,491,355
Acquisition of property	(728,012)	(575,000)
Net change in non-cash working capital (note 18)	(4,346,263)	1,165,765
	(53,867,136)	(4,741,596)
Foreign exchange gain on cash held in foreign currency	(46,519)	-
Change in cash and cash equivalents during the year	(555,346)	1,026,081
Cash and cash equivalents, beginning of year	1,380,569	354,488
Cash and cash equivalents, end of year	\$ 825,223	\$ 1,380,569

Supplemental information (note 18)

See accompanying notes to consolidated financial statements.

# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2008 and 2007

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## 1. Basis of presentation:

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Arsenal Energy Inc. ("Arsenal" or the "Company") is incorporated under the laws of the province of Alberta. The principal business of the Company is the exploration for, exploitation, development, and production of petroleum and natural gas reserves in Canada and the United States. Each country in which Arsenal conducts business has been treated as an identifiable reporting segment, refer to note 19 for additional disclosures. All amounts are reported in Canadian dollars unless otherwise noted.

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## 2. Future operations:

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As at December 31, 2008, the Company has a working capital deficiency of \$44.0 million and has incurred significant losses to date. The future operations of the Company is dependant on its ability to successfully explore, exploit, develop, and produce economically viable reserves and market petroleum and natural gas products from its properties, raise capital to supports its activities and meet its obligations and on receiving the continued financial support from its lender (see note 10).

These financial statements have been prepared on the going concern basis which presumes that the Company will be able to discharge its obligations and realize its assets in the normal course of business at the values at which they are carried in these financial statements, and that the Company will be able to continue its business activities.

Management believes that the going concern assumption is appropriate for these financial statements. If this assumption were not appropriate, adjustments to the carrying amounts of the assets and liabilities, revenues and expenses and the balance sheet classifications used may be necessary.

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## 3. Significant accounting policies:

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These consolidated financial statements include the accounts of Arsenal and its subsidiaries. These consolidated financial statements are stated in Canadian dollars and have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). The preparation of financial statements in conformity with Canadian GAAP requires the Company's management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the period. Actual results could differ from those estimates and assumptions. In the opinion of management, these financial statements have been prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

### a) Revenue recognition:

Revenue associated with the sale of crude oil, natural gas, and natural gas liquids owned by the Company are recognized when title passes from the Company to its customers.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 3. Significant accounting policies (continued):

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### b) Property, plant and equipment:

Arsenal uses the full cost accounting method for oil and gas exploration, development, and production activities. The cost of acquiring oil and natural gas properties as well as subsequent development costs are capitalized and accumulated in each country. Maintenance and repairs are charged against income, and renewals and enhancements, which extend the economic life of the property, plant and equipment, are capitalized. Gains and losses are not recognized upon disposition of oil and natural gas properties unless such a disposition would alter the rate of depletion by at least 20%.

### c) Ceiling test:

A ceiling test is performed at least annually to assess the carrying value of oil and gas assets. A cost center is defined on a country by country basis, and is tested for recoverability using undiscounted future cash flows from proved reserves and forward indexed commodity prices, adjusted for contractual obligations and product quality differentials. A cost center is written down to its fair value when its carrying value, less the lower of cost and market value of unproved properties, is in excess of the related undiscounted cash flows. If the carrying value is not fully recoverable, the amount of impairment is measured by comparing the carrying amounts of the capital assets, less the lower of cost and market value of unproved properties, to an amount equal to the estimated net present value of future cash flows from proved plus probable reserves. This impairment in the carrying amount would be recognized and charged to current operations as an impairment of assets.

### d) Depletion, depreciation and accretion:

In accordance with the full cost accounting method, all crude oil and natural gas acquisition, exploration, and development costs, including asset retirement costs, are accumulated in a cost center. The aggregate of net capitalized costs and estimated future development costs, less the cost of unproved properties and estimated salvage value, is amortized using the unit-of-production method based on current period production and estimated net proved oil and gas reserves as determined by independent engineers. All other equipment is depreciated over the estimated useful life of the respective assets. For purposes of the calculation, petroleum and natural gas reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil equivalent.

### e) Oil and gas reserves:

Oil and gas reserves are based on engineering data, projected future rates of production, estimated commodity prices, and consider the timing of future expenditures. Arsenal expects reserve estimates to be revised based on the results of future drilling activity, testing, production levels, and economics of recovery based on cash flow forecasts.

### f) Income taxes:

Arsenal uses the asset and liability method of accounting for income taxes and records future income taxes for the effect of any difference between the accounting and income tax basis of an asset or liability, using the substantively enacted income tax rates. Accumulated future income tax balances are adjusted to reflect changes in income tax rates that are substantively enacted during the period with the adjustment recognized in net income. Future tax assets are recorded only to the extent it is more likely than not that these assets will be realized. The determination of Arsenal's income and other tax liabilities are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, actual income tax liabilities or recoveries may differ from estimates.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 3. Significant accounting policies (continued):

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### g) 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 and other dilutive instruments. Diluted calculations reflect the weighted average incremental common shares that would be issued upon exercise of dilutive options assuming proceeds would be used to repurchase shares at average market prices for the period. Anti-dilutive options are not included in the calculation.

### h) Measurement uncertainty:

The timely preparation of financial statements in conformity with Canadian generally accepted accounting principles requires that management make estimates and assumptions and use judgment regarding assets, liabilities, revenues, and expenses. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, actual results may differ from estimated amounts as future confirming events occur.

Amounts recorded for depreciation, depletion, and amortization, asset retirement costs and obligations, and amounts used for ceiling test and impairment calculations are based on estimates of oil and natural gas reserves and future costs required to develop those reserves. By their nature, these estimates are subject to measurement uncertainty, and the impact on the financial statements of future periods could be material.

### i) Foreign currency translation:

The Company translates foreign currency denominated transactions and the financial statements of integrated foreign operations using the temporal method. Monetary assets and liabilities are translated at year-end rates. Non-monetary assets and liabilities are translated at rates in effect on the dates of the transactions. Income and expenses are translated at average rates in effect during the year with the exception of amortization, which is translated at historic rates. Exchange gains and losses on translation of monetary assets and liabilities are reflected in income immediately.

### j) 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.

### k) Asset retirement obligations:

The Company recognizes the fair value of an asset retirement obligation as a liability at the time it incurs a legal obligation for the future abandonment and reclamation costs associated with its petroleum and natural gas operations. Asset retirement obligations are initially measured at their fair value and subsequently adjusted to reflect the passage of time (accretion) and any changes to the estimated cash flows underlying the obligation. The associated asset retirement cost is capitalized as part of property, plant and equipment and amortized to earnings using the unit of production method over estimated proved reserves consistent with the depletion and depreciation of the underlying asset.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 3. Significant accounting policies (continued):

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### l) Financial instruments:

Cash and cash equivalents and reclamation bonds are designated as "held-for-trading" and are measured at carrying value, which approximates fair value due to the short-term nature of these instruments. Accounts receivable are designed as "loans and receivables." Accounts payable and accrued liabilities, revolving demand loan and convertible debt are designated as "other liabilities."

The Company uses financial instruments for non-trading purposes to manage fluctuations in commodity prices. All unrealized derivative financial instruments that either do not qualify as hedges, or are not designated as hedges, are recorded as a derivative asset or a derivative liability on the consolidated balance sheet with any changes in fair value during the period recognized in income.

All financial instruments are required to be measured at fair value on initial recognition of the instrument, except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as "held-for trading," "available-for-sale," "held-to-maturity," "loans and receivables" or "other financial liabilities" as defined by the standard.

Financial assets and financial liabilities classified as "held-for-trading" are measured at fair value, with changes in those fair values recognized in net earnings. Financial assets classified as "available-for-sale" are measured at fair value, with changes in those fair values recognized in other comprehensive income. Financial assets classified as "held-to-maturity," "loans and receivables" and "other financial liabilities" are measured at amortized cost using the effective interest method of amortization. The methods used by the Company in determining fair value of financial instruments are unchanged as a result of implementing the new standard.

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## 4. Change in accounting policies:

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### Accounting Changes

#### *Financial Instruments - Disclosure and Presentation*

The Company has adopted new accounting standards concerning the presentation and disclosure of financial instruments. These standards require prospective application and became effective January 1, 2008. The Company applied the new accounting standards at the beginning of its fiscal year.

The adoption of these standards has had no impact on the Company's earnings or cash flows.

#### *Capital Disclosures*

Effective January 1, 2008, the Company adopted new standards for Capital Disclosures which establishes standards for disclosing information that enables users of financial statements to evaluate the entity's objectives, policies and processes for managing capital. The new requirements are for disclosure only and did not impact the financial results of the Company.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 4. Change in accounting policies (continued):

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### Pending Accounting Pronouncements

#### *Goodwill and intangible assets*

New standards for Goodwill and Intangible Assets effective for fiscal years beginning on or after October 1, 2008, provide guidance on the recognition, measurement, presentation and disclosure for goodwill and intangible assets, other than the initial recognition of goodwill or intangible assets acquired in a business combination. Retroactive application to prior-period financial statements will be required. The Company is still assessing the impact of this new standard on its financial statements.

#### *Business combinations*

New standards for Business Combinations, and related standards for non-controlling interests and consolidated financial statements are effective January 1, 2011 and apply prospectively to business combinations for which the acquisition date is on or after the first annual reporting period beginning on or after January 1, 2011 for the Company. Early adoption is permitted. These standards harmonize the Canadian standards with IFRS.

#### *International Financial reporting Standards ("IFRS")*

In February 2008, the CICA Accounting Standards Board ("AcSB") confirmed the changeover to IFRS from Canadian GAAP will be required for publicly accountable enterprises for interim and annual financial statements effective for fiscal years beginning on or after January 1, 2011, including comparatives for 2010.

The International Accounting Standards Board ("IASB") has also issued an exposure draft relating to certain amendments and exemptions to IFRS 1. It is anticipated that this exposure draft will not result in an amended IFRS 1 standard until late 2009. The amendment, if implemented, will permit the Company to apply IFRS prospectively by utilizing its current reserves at the transition date to allocate the Company's full cost pool, with the provision that a ceiling test, under IFRS standards, be conducted at the transition date.

Although the amended IFRS 1 standard would provide relief, the changeover to IFRS represents a significant change in accounting standards and the transition from current Canadian GAAP to IFRS will be a significant undertaking that may materially affect the Company's reported financial position and reported results of operations.

In response, the Company has initiated its high-level IFRS changeover plan and will establish a preliminary timeline for the execution and completion of the conversion project. The changeover plan followed a preliminary assessment of the differences between Canadian GAAP and IFRS and the potential effects of IFRS to accounting and reporting processes, information systems, business processes and external disclosures. This assessment has provided insight into what are anticipated to be the most significant areas of difference applicable to the Company.

During the next phase of the project, scheduled to take place during 2009, the Company will perform an in-depth review of the significant areas of difference, identified during the preliminary assessment, in order to identify all specific Canadian GAAP and IFRS differences and select ongoing IFRS policies. Key areas addressed will also be reviewed to determine any information technology issues, the impact on internal controls over financial reporting and the impact on business activities including the effect, if any, on covenants and compensation arrangements. External advisors may be retained to assist management with the project on an as needed basis. Staff training programs will commence in 2009 and be ongoing as the project unfolds.

The Company will also continue to monitor standards development as issued by the IASB and the AcSB as well as regulatory developments as issued by the Canadian Securities Administrators (CSA), which may affect the timing, nature or disclosure of its adoption of IFRS.

# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 5. Business acquisition:

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On October 8, 2008 Arsenal acquired all of the issued and outstanding securities of GEOCAN Energy Inc. ("GEOCAN"). The operating results of GEOCAN were included in the accounts of Arsenal from October 8, 2008 or "date of acquisition". The purchase method of accounting was used for both the business combination and the allocation of the purchase price and consideration is as follows:

Net assets acquired at assigned values:

Working capital deficiency	\$ (2,235,190)
Bank debt	(11,040,973)
Risk management liability	(476,641)
Property, plant and equipment	59,657,382
Asset retirement obligations	(5,154,550)
Future income taxes	<u>(1,884,347)</u>

Net assets acquired 38,865,681

Consideration:

Cash	\$ 30,000,000
Shares issued	8,445,681
Acquisitions costs	<u>420,000</u>

Purchase price \$ 38,865,681

The Company issued 10,623,498 common shares at \$0.795 as the share consideration for the acquisition. The value of the shares was based on a weighted average trading price of the shares beginning two days before and ending two days after the announcement date of the acquisition.

The above amounts are estimates made by management based on currently available information. Amendments may be made to the purchase price equation as the cost estimates and balances are finalized.

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## 6. Related party transactions:

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An officer of the Company is a partner in a law firm that provides legal services to the Company. In 2008, the Company incurred a total of \$307,485 (2007 - \$ 265,837) for legal fees and disbursements. December 31, 2008 accounts payable and accrued liabilities include \$23,166 (2007 - \$142,170) relating to these payments.

In December 2008, various officers and directors participated in the common share and flow-through share offering of the Company on the same terms as the other subscribers (see note 14(b) and (c)).

In December 2007, various officers and directors participated in the flow-through share offering of the Company on the same terms as the other subscribers (see note 14(c)).

All related party transactions occur in the normal course of operations and have been recorded at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

7. Property, plant and equipment:	2008	2007
Petroleum and natural gas properties	\$ 154,923,250	\$ 87,712,152
Production equipment	<u>28,829,593</u>	<u>11,912,419</u>
	183,752,843	99,624,571
Office furniture, equipment, and other	<u>531,743</u>	<u>488,292</u>
	184,284,586	100,112,863
Accumulated depletion and depreciation	<u>(57,052,430)</u>	<u>(38,978,322)</u>
	<u>\$ 127,232,156</u>	<u>\$ 61,134,541</u>

In Canada and the United States, all costs of unproved properties, net of any associated revenues, have been capitalized, and depleted during 2008 and 2007. Future development costs totaling \$4,400,000 (2007 - \$1,400,000) in Canada and \$5,200,000 (2007 - \$1,276,000) in the United States were included in the depletion calculation for the year ended December 31, 2008.

During 2008, the Company recorded an impairment to its Egyptian property of \$495,650 (2007 - \$9,216,387). These costs related to land acquisition costs, evaluation costs, and drilling activities. As at December 31, 2008, the Company had written off its interest in its Egyptian concession.

During 2007, the Company compared the fair value of goodwill to the carrying amount of goodwill. As a result of this test, the Company recorded an impairment to goodwill of \$4,791,561 calculated as the excess of the Company's fair value over the identifiable net assets for its Canadian reporting unit.

For the year ended December 31, 2008, Arsenal capitalized general and administrative expenses of \$472,321 (2007 - \$689,002) including \$140,342 (2007 - nil) of stock based compensation and \$58,727 of future taxes related thereto.

## 8. Ceiling test:

On December 31, 2008 Arsenal completed a ceiling test on its Canadian and US cost centers to assess if the property, plant and equipment costs would be recoverable by comparing the fair value of the cost centre to the carrying amount. The prices used in the ceiling test evaluation of Arsenal's natural gas, crude oil, and natural gas liquids reserves at December 31, 2008 were as follows:

Year	Heavy Oil 12 <sup>0</sup> Hardisty	NYMEX Gas (\$U.S./mcf)	WTI Oil (\$U.S./bbl)	AECO Gas (CDN\$/mcf)	U.S.\$/CAD\$ Exchange Rates
2009	35.40	6.50	55.00	7.00	0.82
2010	49.20	7.65	76.50	8.05	0.86
2011	54.50	8.30	88.45	8.20	0.90
2012	60.30	9.55	100.80	9.00	0.95
2013	68.05	10.30	108.25	9.75	0.95
2014	70.25	10.50	110.40	9.95	0.95
2015	72.55	10.70	112.60	10.15	0.95
2016	74.90	10.90	114.85	10.35	0.95
2017	77.25	11.15	117.15	10.55	0.95
2018	79.70	11.35	119.50	10.75	0.95
Thereafter	+ 2%	+ 2%	+ 2%	+ 2%	0.95

# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 8. Ceiling test (continued):

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Pursuant to the ceiling test calculations, the Company concluded that no impairment exists as at December 31, 2008.

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## 9. Reclamation bonds:

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At December 31, 2008 the Company had \$213,272 (2007 - \$173,577) on deposit with the United States Federal and State governments for future site reclamation activities. These funds will be returned when the Company abandons and reclaims well sites in the United States.

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## 10. Revolving demand loan:

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At December 31, 2008, the Company had a demand operating loan facility in the amount of \$55,000,000. Debt under the facility, which includes bank debt and working capital, amounted to \$48,479,097 at December 31, 2008. Working capital includes the convertible debenture but excludes risk management contracts and future income taxes whether current assets or current liabilities.

The facility can be utilized in either Canadian or United States dollars, bears interest at rates ranging from prime plus 0.10% to prime plus 1.00% on prime based loans and from the base rate plus 1.35% to 2.25% on guaranteed notes. The interest rate is set based on the net debt to trailing funds flow (funds flow for the last quarter annualized) ratio. The facility is secured by a fixed and floating charge debenture providing a fixed charge over all present and after acquired petroleum and natural gas interests and a floating charge over all lands and a continuing guarantee from the Company's United States subsidiary in the form of a Mortgage Security Agreement and Letter of Undertaking limited to \$8,000,000.

The amount of the facility is subject to a borrowing base test performed on a periodic basis by the lender, based primarily on reserves and using commodity prices estimated by the lender, as well as other factors. A decrease in the borrowing base could result in a reduction to the credit facility. The next such review is scheduled for no later than May 31, 2009.

The Company is bound by certain covenants in its operating loan facility. A financial covenant places a restriction that the working capital ratio does not fall below 1 : 1. The Company is in compliance with its covenant at December 31, 2008.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 11. Income taxes:

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The tax provision differs from the amount computed by applying the combined Canadian federal and provincial income tax statutory rates to loss before income taxes as follows:

	<u>2008</u>	<u>2007</u>
Income (loss) before income taxes	\$ 20,344,122	\$ (30,550,664)
Combined federal and provincial tax rate	29.83%	34.59%
Expected tax provision (recovery)	6,068,892	(10,567,475)
Increase (decrease) in taxes resulting from:		
Stock-based compensation	245,877	243,783
Change in tax rates	(354,501)	2,484,153
Tax impact of foreign jurisdictions	(2,049,732)	-
Goodwill impairment	-	1,657,323
Income tax adjustments	1,047,135	(684,274)
Flow through share adjustments	-	(235,055)
Change in valuation allowance	868,921	-
Other	<u>(71,647)</u>	<u>(70,119)</u>
	<u>\$ 5,754,945</u>	<u>\$ (7,171,664)</u>

The net future income tax liability is comprised of the tax effect of temporary differences as follows:

	<u>2008</u>	<u>2007</u>
Future tax liability:		
Property, plant and equipment	\$ 18,723,913	\$ 8,974,708
Share issue costs	(512,957)	(1,000,992)
Asset retirement obligations	(3,898,228)	(1,069,011)
Unrealized foreign exchange gain	168,818	119,263
Unrealized gain on commodity contracts	2,870,832	-
Capital losses	(4,544,278)	(3,391,087)
Net capital losses	(868,921)	-
Valuation allowance	868,921	-
Other	<u>-</u>	<u>(10,981)</u>
Net future income tax liability	<u>\$ 12,808,100</u>	<u>\$ 3,621,900</u>

The Company has non-capital losses of approximately \$9.6 million as at December 31, 2008 which commence expiry in 2010.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 12. Convertible debentures:

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Arsenal completed the corporate acquisition of Tiverton on March 14, 2006. A portion of Tiverton's capital structure was comprised of unsecured convertible debentures totaling \$3,480,000. The convertible debentures are a debt security with an embedded conversion option and were segregated into a debt and equity component based on the respective fair value of each at the date of acquisition. The equity component of \$370,000 represents the holder's conversion right and was included in Shareholders' Equity. The remaining balance was classified as debt and is being accreted over the remaining period to maturity to the face value of the debenture. The interest accrues on the debentures at 8%, payable semi-annually on June 30th and December 31st of each year. The debentures matured on February 15, 2009 and were repaid by the Company at that time.

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## 13. Asset retirement obligations:

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The Company's asset retirement obligations result from the net ownership interest in petroleum and natural gas assets including well sites, gathering systems and processing facilities.

The following table presents the reconciliation of the beginning and ending aggregate carrying amount of the obligations associated with the retirement of oil and gas properties:

Changes to the asset retirement obligations were as follows:

	<u>2008</u>	<u>2007</u>
Asset retirement obligations, beginning of year	\$ 3,697,721	\$ 2,638,520
Liabilities settled	(525,475)	(321,190)
Liabilities acquired	5,214,917	1,251,400
Liabilities incurred	521,277	-
Change in estimate	5,262,397	(76,559)
Accretion expense	<u>327,225</u>	<u>205,550</u>
Asset retirement obligations, end of year	<u>\$ 14,498,062</u>	<u>\$ 3,697,721</u>

For the year ended December 31, 2008, the Company has changed its estimated costs to reclaim and abandon the wells, gathering systems and facilities and the estimated timing of the costs to be incurred in future periods resulting in an increase of \$5,262,397.

The total undiscounted amount of estimated cash flows required to settle the obligation is \$34.4 million (2007 - \$8.6 million), which has been discounted using a credit-adjusted risk free rate of 8.0% (2007 - 8.0%) and an inflation factor of 1.5% (2007 - 1.5%). The majority of these obligations will be incurred between 2017 and 2022; however approximately \$7.6 million in obligations are not anticipated to be incurred until after 2030.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

## 14. Shareholder's equity:

### a) Authorized:

Unlimited number of common shares  
Unlimited number of non-voting preferred shares, issuable in series.

### b) Issued:

	2008		2007	
	Number	Amount	Number	Amount
Common shares:				
Balance, beginning of year	83,698,042	\$ 81,676,603	73,642,173	\$ 80,516,169
Issued to acquire GEOCAN	10,623,498	8,445,681	—	—
Issued to acquire property	—	—	275,000	158,000
Issued on exercise of options	283,251	90,217	73,333	14,667
Issued for cash pursuant to private placement	1,249,300	787,059	—	—
Issued for cash pursuant to private placement of flow-through shares	5,555,555	4,000,000	9,707,536	4,174,240
Tax effect of flow-through shares	—	(1,356,625)	—	(2,660,118)
Share issue costs	—	(392,062)	—	(443,855)
Tax effect of share issue costs	—	127,425	—	142,500
Allocated from contributed surplus	—	60,490	—	—
Forgiveness of loan (note d)	—	225,000	—	—
Normal Course Issuer Bid	(160,000)	(147,863)	—	—
Shares held in escrow (note d)	—	—	—	(225,000)
Balance	<u>101,249,646</u>	<u>\$ 93,515,925</u>	<u>83,698,042</u>	<u>\$ 81,676,603</u>

In connection with the acquisition of GEOCAN (note 5) the Company issued 10,623,498 common shares in exchange for all of the common shares of GEOCAN.

In March and April 2008, the Company issued 289,500 and 959,800 common shares at \$0.63 for gross proceeds of \$787,059, of which an officer of the Company subscribed for 289,500 shares for gross proceeds of \$182,385.

In May 2007, the Company issued 275,000 common shares at \$0.575 to purchase certain producing assets for \$158,000.

### c) Flow-through shares:

In March and April 2008, the Company issued 5,555,555 flow-through shares at \$0.72 per share for gross proceeds of \$4,000,000, for which officers of the Company subscribed for 34,000 flow-through shares for gross proceeds of \$24,480. The terms of the share issue requires the Company to renounce to subscribers Canadian Exploration Expenses in the amount of \$4,000,000 of which \$3,900,000 will need to be incurred prior to December 31, 2009.

In November and December 2007, the Company issued 9,707,536 flow-through shares at \$0.63 per share for gross proceeds of \$4,174,240. Certain officers, directors and insiders of the Company subscribed for 753,628 flow-through shares for gross proceeds of \$324,060.

# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 14. Shareholder's equity (continued):

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In 2007, Canada Revenue Agency ("CRA") conducted an audit of prior years flow-through share offerings of a previously acquired company. CRA had proposed to reduce the amount claimed as Qualifying Expenditures and to assess additional interest costs. As a result of the reduction in Qualifying Expenditures and the indemnity given by the acquired company in the various subscription agreements, the Company recorded a liability of \$1,300,000 in 2007 for the proposed income tax assessed the subscribers for the shortfall in Qualifying Expenditures and \$424,061 in additional interest costs. Finance charges for 2007 were increased by \$1,724,061 to total \$2,941,047.

In 2008, the Company and CRA completed their review and discussions on the audit of the Qualifying Expenditures and the related interest costs which resulted in a recovery of finance charges of \$693,764. Finance charges for 2008 represents interest paid on the Company's line of credit of \$795,667, other interest costs of \$29,908 reduced by the recovery of previously recorded interest costs in the amount of \$1,519,339.

**d) Escrowed shares:**

The Company issued shares, by virtue of a loan in a prior year to a former officer and director of the Company. During 2008, the loan was forgiven and at December 31, 2008, \$Nil (December 31, 2007 - \$225,000) of these shares were held in escrow and recorded against share capital.

**e) Per share amounts:**

The following table shows the weighted average number of common and diluted shares.

	<u>2008</u>	<u>2007</u>
Basic and diluted:		
Income (loss) per share	\$ 0.16	\$ (0.31)
Shares outstanding:		
Basic	88,937,656	74,419,541
Diluted	89,199,940	74,419,541

In calculating the per share amounts for the year ended December 31, 2008, 6,155,038 options and the impact of the convertible debentures were excluded from the dilution calculation, as they were anti-dilutive. No adjustments were required to reported earnings in computing diluted per share amounts.

**f) Normal course issuer bid:**

In October 2008, the Company received approval for a normal course issuer bid (NCIB) program for the repurchase and cancellation of its common shares. The program was initiated in October 2008 to repurchase up to 4,539,307 of its common shares during the period from October 16, 2008 to October 15, 2009. Any purchases will be made on the open market through the TSX at the market price of such shares at the time of acquisition. During 2008, the Company repurchased and cancelled 160,000 shares at a cost of \$31,200. The stated value of these shares exceeded their cost by \$116,663 (see note 15(b)). This excess has been recorded to contributed surplus.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

## 15. Stock options:

The Company has a stock option plan in which the Company may grant options to its directors, officers, employees and consultants for up to 10% of its outstanding common shares. Under the plan, the exercise price of each option granted shall not be less than the market price of the Company's common shares on the date the option is granted and the contractual term of each option is not to exceed five years. All options vest over a period as determined by the Board of Directors. Stock options are granted periodically throughout the year.

The following table summarizes the status of the Company's stock option plan as at December 31, 2008 and December 31, 2007 and the changes during those years:

	2008		2007	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Balance, beginning of year	3,758,919	\$ 0.88	4,527,252	\$ 1.05
Granted	4,296,000	0.55	995,000	0.40
Exercised	(283,251)	0.32	(73,333)	0.20
Forfeited	<u>(410,668)</u>	<u>1.01</u>	<u>(1,690,000)</u>	<u>1.08</u>
Balance, end of year	<u>7,361,000</u>	<u>\$ 0.70</u>	<u>3,758,919</u>	<u>\$ 0.88</u>
Exercisable	<u>3,962,334</u>	<u>\$ 0.86</u>	<u>2,854,752</u>	<u>\$ 1.01</u>

The following table summarizes information about the stock options outstanding and exercisable at December 31, 2008:

Exercise Price Range	Options outstanding			Options exercisable	
	Number	Weighted average exercise price	Weighted average remaining Term (years)	Number	Weighted average exercise price
\$ 0.20 - \$0.59	2,823,000	\$ 0.40	3.88	1,006,667	\$ 0.45
0.60 - 1.10	3,048,000	0.73	4.02	1,465,667	0.78
1.11 - 1.25	1,335,000	1.19	1.14	1,335,000	1.19
1.26 - 2.00	<u>155,000</u>	<u>1.37</u>	<u>1.71</u>	<u>155,000</u>	<u>1.37</u>
Total	<u>7,361,000</u>	<u>\$ 0.70</u>	<u>3.40</u>	<u>3,962,334</u>	<u>\$ 0.86</u>

# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 15. Stock options (continued):

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### a) Stock-based compensation expense:

Options granted to employees and non-employees are accounted for using the fair value method. The fair value of stock options granted during 2008 was \$2,057,684 (\$0.48 per option) (2007 - \$328,019 (\$0.33 per option)) as estimated at the date of grant using the Black-Scholes option-pricing model with weighted average assumptions for grants as follows:

	<u>2008</u>	<u>2007</u>
Risk free rate	2.64 – 3.25%	4.5%
Expected life	5 years	5 years
Expected volatility	125 – 137%	152%
Expected dividend	nil	nil
Expected forfeitures	nil	nil

### b) Contributed surplus:

The estimated fair value of the options, at the time of grant, is amortized and credited to contributed surplus over the option vesting period on a straight line basis. The change in the contributed surplus account is reconciled in the table below:

	<u>2008</u>	<u>2007</u>
Balance, beginning of year	\$ 3,430,965	\$ 2,422,423
Stock-based compensation expensed	824,263	704,811
Stock-based compensation capitalized	140,342	–
Reclassification of options exercised	(60,490)	–
Reclassification on expiry of warrants	–	303,731
Premium on NCIB (note 14(f))	<u>116,663</u>	<u>–</u>
Balance, end of year	<u>\$ 4,451,743</u>	<u>\$ 3,430,965</u>

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## 16. Risk management and financial instruments:

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### a) Commodity price risk management:

As at December 31, 2008, the Company has two crude oil sales contracts and one natural gas sales contract in-place fixing the price of future production. All risk management contracts are denominated in Canadian dollars. As at December 31, 2008, the Company recorded a realized commodity contract gain of \$7,424,828 and an unrealized commodity contract gain of \$9,045,804 of which \$6,696,175 has been recorded as a current asset and \$2,349,629 has been recorded as a long term asset. The Company has one risk management contract relating to US production and has recorded the related future income tax liability amount of \$900,000 as a current liability as a result of the current unrealized gain of \$2,250,440. The remaining two contracts relate to Canadian production and the Company has recorded the related future income tax liability amount of \$1,990,600 (\$1,302,600 as a current liability and \$688,000 as a long term liability) as a result of the unrealized gain of \$6,795,364 (\$4,445,735 current unrealized gain and \$2,349,629 long term unrealized gain).

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 16. Risk management and financial instruments (continued):

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During 2008, the Company had fixed the price applicable to future production and recorded realized and unrealized gains as follows:

Hedge Type	Production Per Day	CDN \$ Price	Terminates	Realized	Gain (Loss) Unrealized	Total
Oil (barrels)	200	97.55	Dec 31, 2009	\$ 521,331	\$ 2,250,440	\$ 1,729,109
Oil (barrels)	100	109.80	Dec 31, 2009	1,593,997	-	1,593,997
Oil (barrels)	300	130.10	July 31, 2009	5,222,127	-	5,222,127
Oil (barrels)	200	125.80	July 31, 2010	1,130,035	6,394,818	7,524,853
Gas (Gj)	1,000	7.46	Dec 31, 2009	-	400,546	400,546
Gain on commodity contracts				<u>\$ 7,424,828</u>	<u>\$ 9,045,804</u>	<u>\$16,470,632</u>

In November 2008, the Company monetized its commodity hedge on 300 barrels per day at \$130.10 and in December 2008, monetized its commodity hedge on 100 barrels per day at \$109.80.

As at December 31, 2008, the Company had fixed the price applicable to future production as follows:

Hedge Type	Production Per Day	CDN \$ Price	Terminates
Oil (barrels)	200	97.55	Dec 31, 2009
Oil (barrels)	200	125.80	July 31, 2010
Gas (Gj)	1,000	7.46	Dec 31, 2009

Commodity price sensitivity:

A \$1.00 change in the "NYMEX WTI" Canadian crude price would change the hedging gain or loss by approximately \$188,000. A \$0.10 change in the "AECO C" Canadian natural gas price would change the hedging gain or loss by approximately \$36,500.

### b) Fair value of financial instruments:

The Company's exposure under its financial instruments is limited to financial assets and liabilities, all of which are included in these financial statements. The fair values of financial assets, liabilities, and convertible debentures that are included in the balance sheet approximate their carrying amounts.

### c) Credit risk:

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint interest partners and petroleum and natural gas marketers.

A substantial portion of the Company's accounts receivable are with customers and joint interest partners in the oil and gas industry and are subject to normal market and industry credit risks.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 16. Risk management and financial instruments (continued):

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As at December 31, 2008 the Company's receivables consisted of \$1,055,623 (December 31, 2007 - \$1,120,874) from joint interest partners most of which has either been collected, is expected to be collected within the next 60 days or will be offset against joint interest payables, \$3,224,180 (December 31, 2007 - \$2,414,957) of receivables from petroleum and natural gas marketers of which approximately \$3.0 million has been collected and \$1,570,566 (December 31, 2007 - \$224,742) of other receivables of which \$1.2 million is refundable from US tax authorities and is expected to be collected within the next 180 days. At December 31, 2008, Arsenal had approximately \$500,000 of receivables that are considered past due and collection efforts, including the taking of production and consideration of legal action have commenced.

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint interest receivables are typically collected within one to three months of the joint interest bill being issued to the partner. The Company attempts to mitigate the risk from joint interest receivables by obtaining partner approval of significant capital expenditures and payment of cash advances prior to expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances are dependent on industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition further risk exists with joint interest partners as disagreements occasionally arise that increase the potential for non-collection. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint interest partners; however the Company does have the ability to request deposits and to withhold production from joint interest partners in the event of non-payment.

The carrying amount of cash and cash equivalents and accounts receivable represents the maximum credit exposure. The Company did not have an allowance for doubtful accounts as at December 31, 2008 (December 31, 2007 - \$422,316) as all doubtful accounts have been written off.

**d) Foreign currency exchange risk:**

The Company is exposed to foreign currency fluctuations as crude oil and natural gas prices received are referenced to United States dollar denominated prices, and revenues earned and costs incurred in the United States are denominated in United States dollars. The Company has mitigated a portion of this exchange risk by entering into fixed Canadian dollar crude oil price swaps as outlined in the commodity price risk section above. A \$0.01 increase or decrease in the Canadian/United States foreign exchange rate would increase or decrease, as the case may be, net income by \$36,669.

**e) Interest rate risk:**

The Company is exposed to interest rate risk to the extent that the revolving demand loan is at a floating rate of interest. Based on \$17.6 million average bank debt outstanding over the year ending December 31, 2008, a 100 basis point (1%) change in the interest rate would increase or decrease interest expense for the year by \$175,863.

All debt is denominated in Canadian dollars.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 16. Risk management and financial instruments (continued):

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### f) Liquidity risk:

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as much as possible, that it will always have sufficient liquidity to meet its liabilities when due, under normal and stressed conditions. Management closely monitors cash flow requirements to ensure that it has sufficient cash on demand or borrowing capacity to meet operational and financial obligations over the next two years. At December 31, 2008, the Company had a \$55.0 million demand operating line of credit. The Company's financial liabilities include a revolving demand loan and convertible debentures which are current and due within one year (see note 12).

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## 17. Capital management:

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In order to continue the Company's future exploration and development program, the Company must maintain a strong capital base. A strong capital base results in increased market confidence, an essential factor in maintaining existing shareholders and in attracting new investors. The Company's commitment is to establish and maintain a strong capital base to enable the Company to access the equity and debt markets when deemed advisable. In order to maintain a strong capital base, the Company continually monitors the risk reward profile of its exploration and development projects and the economic indicators in the market including commodity prices, interest rates and foreign exchange rates. It then determines increases or decreases to its capital budget.

The Company considers shareholders' equity, bank debt and working capital (excluding the fair value of risk management contracts and current future income taxes) as components of its capital base. The Company can access or increase capital through the issuance of shares, through bank borrowings, that are based on reserves, and by building cash reserves by reducing its capital expenditure program.

The Company monitors its capital based primarily on its net debt (including the convertible debentures) to annualized funds flow ratio, a non-GAAP financial measure. Debt includes bank debt plus or minus working capital. Annualized funds flow is calculated as cash flow from operations before changes in non-cash working capital from the Company's most recent quarter multiplied by four. The Company's strategy is to maintain this ratio at approximately 1 : 1. This ratio may increase somewhat depending on the timing and nature of the Company's activities. To facilitate the management and control of this ratio, the Company prepares an annual operating and capital expenditure budget. The budget is updated when critical factors change. These factors include economic factors such as the state of equity markets, changes to commodity prices, interest rates and foreign exchange rates and non economic factors such as the Company's drilling results and its production profile. The Company's Board of Directors approves the budget and changes thereto.

At December 31, 2008, the Company's debt to funds flow ratio is 1.07 : 1. The ratio fluctuates quarterly based on the timing of the Company's capital expenditure program, operating activities and financing activities.

The Company's current credit facility has a financial covenant that, without the written consent of the lender, would result in a breach of the agreement. The Company cannot permit:

- the working capital ratio (as defined in the agreement to include the unutilized portion of the facility) to fall below 1 : 1

At December 31, 2008, the Company has complied with this external financial covenant.

# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 17. Capital management:

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The Company's share capital is not subject to external restrictions.

There were no changes in the Company's approach to capital management during the year.

	Year Ended December 31, 2008
Revolving demand loan	\$ 42,002,004
Working capital deficiency (excluding risk management contracts and future income tax)	3,014,004
Convertible debentures	<u>3,463,089</u>
Total debt	<u>\$ 48,479,097</u>
Annualized funds flow	\$ 45,265,844
Net debt to annualized funds flow ratio	1.07

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## 18. Supplemental cash flow information:

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	2008	2007
Change in non-cash working capital items:		
Accounts receivable	\$ 872,503	\$ 3,492,891
Prepays and deposits	(176,426)	-
Accounts payable and accrued liabilities	<u>(5,812,902)</u>	<u>5,866,240</u>
	<u>(5,116,825)</u>	<u>9,359,131</u>
Amounts relating to operating activities	(745,930)	8,138,366
Amounts relating to investing activities	(4,346,263)	1,165,765
Amounts relating to financing activities	(24,632)	55,000
Interest and taxes paid:		
Taxes paid	\$ 107,243	\$ -
Interest paid	<u>\$ 825,575</u>	<u>\$ 1,238,218</u>

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During 2008, the Company made tax installment payments of \$651,000 to US federal and state tax authorities. Of the total paid, \$107,243 was applied to a previous year and because the Company was not taxable in the US in 2008, the remainder will be refunded.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 19. Segmented information:

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A portion of the Company's assets and revenues are earned in the United States and a portion of the Company's assets are located in Egypt, and are monitored as an identifiable reporting segment by management. The remaining assets and associated revenues are earned in Canada by Arsenal Energy Inc. Business risks and economic indicators are similar across all geographical regions.

2008 (\$CDN)	<u>Canada</u>	<u>U.S.</u>	<u>Egypt</u>
Oil and gas revenue	42,496,396	11,983,129	-
Income (loss) before income taxes	17,225,337	3,854,383	(735,598)
Operating income	38,048,416	6,402,959	-
Property, plant, and equipment (note 7)	120,127,509	7,104,647	-
GEOCAN acquisition	59,657,382	-	-
Capital expenditures (including acquisitions)	19,868,461	2,196,411	-

  

2007 (\$CDN)	<u>Canada</u>	<u>U.S.</u>	<u>Egypt</u>
Oil and gas revenue	22,602,228	9,271,041	-
Income (loss) before income taxes	(22,740,901)	2,294,081	(10,103,844)
Operating income	7,324,118	3,554,812	-
Property, plant, and equipment (note7)	56,653,331	3,985,560	495,650
Capital expenditures (including acquisitions)	17,996,192	318,088	3,084,436

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## 20. Commitments and contingencies:

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**a) Flow-through shares:**

In connection with the issuance of flow-through shares in 2008, the Company incurred a commitment to incur \$4,000,000 of eligible expenditures by December 31, 2009. As at December 31, 2008, the Company had approximately \$3,900,000 remaining on its commitment.

**b) Office lease:**

The Company leases its office premises through an operating lease for accounting purposes. The estimated operating lease commitments relating to leased office premises are as follows:

	<u>(\$CDN)</u>
2009	632,192
2010	632,192
2011	632,192
2012	368,779

**c) Outstanding lawsuits:**

Various lawsuits have been filed against the Company for incidents which arose in the ordinary course of business. In the opinion of management, the outcome of the lawsuits, now pending, is not determinable or not material to the Company's operation. Should any loss result from the resolution of these claims, such loss will be charged to operations in the year of resolution.

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# ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2008 and 2007

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## 21. Subsequent events:

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- a) On January 2, 2009, the Company granted an aggregate of 1,688,000 stock options to directors, officers and key employees, pursuant to the Company Stock Option Plan, at an exercise price of \$0.205 per share. The options are exercisable for a period of five years.
  - b) On January 2, 2009, the Company terminated one of the crude oil commodity contracts, with a strike price of \$97.55 per barrel, for a realized gain of \$2,055,743.
  - c) On February 2, 2009, the Company put in-place a commodity contract for 1,000 GJ per day of natural gas for the period January 1, 2010 to December 31, 2010 with a strike price of \$6.78 per GJ.
  - d) On February 15, 2009, the convertible debentures of \$3,480,000 (see note 12) were repaid plus accrued interest of \$34,323.
-