

MANAGEMENT DISCUSSION AND ANALYSIS

Basis of Presentation

The following is management's discussion and analysis ("MD&A") of Arsenal Energy Inc.'s ("Arsenal" or the "Company") audited operating and financial results for the year ended December 31, 2008. It should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2008 and other operating and financial information contained herein. This MD&A is dated March 26, 2009.

The financial data presented herein has in part been derived from the Company's annual audited financial statements prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") and in accordance with accounting policies as set out in Notes 3 and 4 to the Company's annual consolidated financial statements. The reporting and the measurement currency is the Canadian dollar.

Additional information regarding Arsenal's financial and operating results may be obtained on the internet at www.sedar.com.

Current Year Accounting Changes

Effective January 1, 2008, Arsenal adopted with prospective effect certain new accounting standards introduced by the Canadian Institute of Chartered Accountants ("CICA") as part of GAAP as follows:

Financial Instrument Disclosure and Presentation

The Accounting Financial Standards Board issued two new sections in relation to financial instruments: "Financial Instruments – Disclosures" (section 3862 of the CICA Handbook), and "Financial Instruments – Disclosures and Presentation" (section 3863 of the CICA Handbook). These new standards have replaced – Financial Instruments – Disclosure and Presentation. The new accounting standards require the Company to provide information about the significance of financial instruments to the Company's financial position and performance and increases the Company's disclosure regarding the nature of the risks associated with financial instruments and how these risks are managed by the Company.

Capital Disclosures

The Company has adopted new standards for "Capital Disclosures" (section 1535 of the CICA Handbook), which requires the Company to disclose its objectives, policies and processes for managing capital (see "Bank Debt, Liquidity and Capital Resources – Capital Management").

Future Accounting Changes

Goodwill and Intangible Assets

The Company has adopted, effective January 1, 2009 new standards for "Goodwill and Intangible Assets" (section 3064 of the CICA Handbook), which establishes standards for the recognition, measurement and disclosure of goodwill and intangible assets subsequent to its initial recognition.

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 interim and annual financial statements effective for fiscal years beginning on or after January 1, 2011. The AcSB issued the "omnibus" exposure draft of IFRS with comments due by July 31, 2008, wherein early adoption by Canadian entities is also permitted. The Canadian Securities Administrators ("CSA") has also issued Concept Paper 52-402, which requested feedback on the early

adoption of IFRS as well as the continued use of US GAAP by domestic issuers. The eventual changeover to IFRS represents a change due to new accounting standards. The transition from current Canadian GAAP to IFRS is a significant undertaking that may materially affect the Company's reported financial position and results of operations.

The IASB issued an exposure draft relating to certain amendments and exemptions to IFRS 1 in order to make it more useful to Canadian entities adopting IFRS for the first time. One such exemption relating to full cost oil and gas accounting is expected to reduce the administrative burden in the transition from the current Canadian Accounting Guideline 16 to IFRS. It is anticipated that this exposure draft will not result in an amended IFRS 1 standard until late 2009. The amendment will potentially permit the Company to apply IFRS prospectively to their full cost pool, rather than the retrospective assessment of capitalized exploration and development expenses, with the proviso that a ceiling test, under IFRS standards, be conducted at the transition date.

Although the Company has not completed development of its IFRS changeover plan, when finalized, it will include project structure and governance, resourcing and training, an analysis of key GAAP differences and a phased plan to assess accounting policies under IFRS as well as potential IFRS 1 exemptions. The Company anticipates completing its project scoping, which will include a timetable for assessing the impact on data systems, internal controls over financial reporting, and business activities, such as financing and compensation arrangements, during 2009.

Disclosure Controls and Procedures

The Company has established disclosure controls and procedures for the timely and accurate preparation of financial and other reports. Disclosure controls and procedures are designed to provide reasonable assurance that material information required to be disclosed is recorded, processed, summarized and reported within the periods specified by applicable securities regulations and that information required to be disclosed is accumulated and communicated to the appropriate members of management and properly reflected in the Company's filings. Consistent with the concept of reasonable assurance, the Company recognizes that the relative cost of maintaining these disclosure controls and procedures should not exceed their expected benefits. As such, the Company's disclosure controls and procedures can only provide reasonable assurance, and not absolute assurance, that the objectives of such controls and procedures are met. The Chief Executive Officer and the Chief Financial Officer oversee this evaluation process and have concluded that the design and operation of these disclosure controls and procedures are not effective in providing reasonable assurance that material information required to be disclosed by the Company in reports filed with Canadian securities regulators is accurate and complete and filed within the periods required due to the material weaknesses identified in internal controls over financial reporting as noted below. The Chief Executive Officer and the Chief Financial Officer have individually signed certifications to this effect.

Internal Controls Over Financial Reporting

The Chief Executive Officer and Chief Financial Officer of Arsenal are responsible for designing and ensuring the operating effectiveness of internal controls over financial reporting or causing them to be designed and operating effectively under their supervision in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. Arsenal's management has assessed the design and operating effectiveness of internal controls over financial reporting.

While Arsenal's Chief Executive Officer and Chief Financial Officer believe the Company's internal controls and procedures provide a reasonable level of assurance that they are reliable, an internal control system cannot

prevent all errors and fraud. It is management's belief that any control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

During the design and operating effectiveness assessment certain material weaknesses in internal controls over financial reporting were identified, as follows:

- Management is aware that there is a lack of segregation of duties due to the small number of employees dealing with general administrative and financial matters. However, management believes that at this time the potential benefits of adding employees to clearly segregate duties do not justify the costs associated with such increase;
- Many of Arsenal's information systems are subject to general control deficiencies including a lack of effective controls over spreadsheets, access and documentation. The Company expects that some deficiencies will continue into the future; and
- Arsenal does not have full-time in-house personnel to address all complex financial and non-routine tax issues that may arise. It is not deemed as economically feasible at this time to have such personnel. Arsenal relies on external experts for review and advice on complicated financial issues and for tax planning, tax provision and compilation of corporate tax returns.

These weaknesses in internal controls over financial reporting result in a more than remote likelihood that a material misstatement would not be prevented or detected. Management and the Board of Directors work to mitigate the risk of material misstatement; however, management and the Board do not have reasonable assurance that this risk can be reduced to a remote likelihood of a material misstatement.

Forward-Looking Statements

Certain statements contained within the Management's Discussion and Analysis, and in certain documents incorporated by reference into this document, constitute forward looking statements. These statements relate to future events or our future performance. All statements other than statements of historical fact may be forward looking statements. Forward looking statements are often, but not always, identified by the use of words such as 'seek', 'anticipate', 'budget', 'plan', 'continue', 'estimate', 'expect', 'forecast', 'may', 'will', 'project', 'predict', 'potential', 'targeting', 'intend', 'could', 'might', 'should', 'believe' and similar expressions. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward looking statements.

In particular, this MD&A contains the following forward-looking statements pertaining to, without limitation, the following: Arsenal's production volumes and the timing of when additional production volumes will come on stream; Arsenal's realized price of commodities in relation to reference prices; future commodity prices; the Company's future royalty rates and the realization of royalty incentives; the impact of the New Royalty Framework on the Company's future royalties; Arsenal's expectation of reducing operating costs on a per unit basis; the relationship of Arsenal's interest expense and the Bank of Canada interest rates; increases in general and administrative expenses and recoveries; future development and exploration activities and the timing thereof; the future tax liability of the Company; the expected decrease the depletion, depreciation and accretion rate; the estimated future contractual obligations of the Company and the amount expected to be incurred under its farm-in commitments; the future liquidity and financial capacity of the Company; and its ability to fund its working capital and forecasted capital expenditures. In addition, statements relating to 'reserves' or 'resources' are deemed to be forward looking statements, as they involve the implied assessment, based on certain estimates and assumptions, that the resources and reserves described can be profitably produced in the future.

With respect to the forward-looking statements contained in the MD&A, Arsenal has made assumptions regarding: future commodity prices; the impact of royalty regimes and certain royalty incentives, the timing and the amount of capital expenditures; production of new and existing wells and the timing of new wells coming on-stream; future proved finding and development costs; future operating expenses including processing and gathering fees; the performance characteristics of oil and natural gas properties; the size of oil and natural gas reserves; the ability to raise capital and to continually add to reserves through exploration and development; the continued availability of capital, undeveloped land and skilled personnel; the ability to obtain equipment in a timely manner to carry out exploration and development activities; the ability to obtain financing on acceptable terms; the ability to add production and reserves through exploration and development activities; and the continuation of the current tax and regulation.

We believe the expectations reflected in those forward looking statements are reasonable but no assurance can be given that these expectations will prove to be correct and such forward looking statements included in, or incorporated by reference into, this MD&A should not be unduly relied upon. These statements speak only as of the date of this MD&A or as of the date specified in the documents incorporated by reference into this Management's Discussion and Analysis, as the case may be. The actual results could differ materially from those anticipated in these forward looking statements as a result of the risk factors set forth below and elsewhere in this Management's Discussion and Analysis: volatility in market prices for oil and natural gas; counterparty credit risk; access to capital; changes or fluctuations in production levels; liabilities inherent in oil and natural gas operations; uncertainties associated with estimating oil and natural gas reserves; competition for, among other things, capital, acquisitions of reserves, undeveloped lands and skilled personnel; stock market volatility and market valuation of Arsenal stock; geological, technical, drilling and processing problems; limitations on insurance; changes in environmental or legislation applicable to our operations, and our ability to comply with current and future environmental and other laws; changes in income tax laws or changes in tax laws and incentive programs relating to the oil and gas industry; and the other factors discussed under "Risk Factors" in the following annual MD&A. Readers are cautioned that the foregoing lists of factors are not exhaustive. The forward looking statements contained in this MD&A and the documents incorporated by reference herein are expressly qualified by this cautionary statement. The forward-looking statements contained in this document speak only as of the date of this document and Arsenal does not assume any obligation to publicly update or revise them to reflect new events or circumstances, except as may be required pursuant to applicable securities laws.

Boe Presentation

For the purpose of calculating unit costs, natural gas is converted to barrel of oil equivalent ("Boe" or "boe") using six thousand cubic feet ("Mcf") of natural gas to one barrel of oil unless otherwise stated. Boe may be misleading, particularly if used in isolation. A Boe conversion ratio of six Mcf to one barrel ("Bbl") is based on an energy equivalency method primarily at the burner tip and does not represent a value equivalency at the wellhead. (This conversion conforms to National Instrument 51-101). References to natural gas liquids ("NGLs") in this MD&A include condensate, propane, butane and ethane and one barrel of NGLs is considered to be equivalent to one barrel of crude oil equivalent (Boe).

Non-GAAP Financial Measurements

Within the MD&A, references are made to terms having widespread use in the oil and gas industry in Canada. The measures discussed are widely accepted measures of performance and value within the industry, and are used by investors and analysts to compare and evaluate oil and gas exploration and producing entities. "Funds from operations", "funds from operations per share", "netbacks" and "netbacks per Boe" are not defined by GAAP in Canada and are regarded as non-GAAP measures. Measurement of funds from operations is detailed on the Consolidated Statement of Cash Flows, specifically; it is cash flow before the change in non-cash operating working capital and asset retirement expenditures. Funds from operations should not be considered as an alternative to, or more meaningful than cash flow from operating activities as determined in accordance with GAAP as an indicator of the Company's performance. The Company's determination of funds from operations may not be comparable to that reported by other companies. Funds from operations per share is calculated based on the weighted average number of common shares outstanding consistent with the calculation of net earnings per share.

(\$Cdn.)	Three Months Ended December 31		Year Ended December 31	
	2008	2007	2008	2007
Cash provided by (used in) operating activities	11,427,654	(2,218,349)	30,019,362	12,093,632
Asset retirement expenditures	485,719	221,205	525,475	321,190
Change in non-cash working capital	(596,912)	446,780	745,930	(9,438,366)
Funds (used in) from operations	11,316,461	(1,550,364)	31,290,767	2,976,456

Netbacks equal total revenue less royalties and operating costs, calculated on a commodity and Boe basis. Total Boe is calculated by multiplying the daily production by the number of days in the year or quarter as the case may be.

COMPANY HIGHLIGHTS

In early 2008, the Company completed an equity issue for gross proceeds of \$4.8 million on the sale of common (\$0.8 million at \$0.63 per share) and flow-through (\$4.0 million at \$0.72 per share) shares.

During the year, the Company completed a number of small non-core property dispositions realizing \$2.9 million and acquired additional working interests in a core property for \$0.7 million.

During 2008, the Company concentrated its acquisition, exploration and development program in low risk areas designed to provide the Company with either a rapid return of capital or a longer reserve life base for the Company.

The Company, during 2008, made progress on reducing field operating costs in Canada and in the US. Operating costs in 2008 averaged \$21.54 per Boe versus \$22.28 per Boe in 2007. Further reductions in the average operating cost per Boe are expected due to operational efficiencies, the shutting-in of high cost production and new lower cost production being added and due to the acquisition of GEOCAN, whose operating costs were slightly lower than Arsenal's due to product mix.

In June 2008, the Company gave notice, effective June 30, 2008, that it was withdrawing from further participation in the Egypt concession.

On October 8, 2008, Arsenal acquired all of the outstanding common shares of GEOCAN Energy Inc. ("GEOCAN") for \$30.0 million cash and the issuance of 10,623,498 Arsenal shares. The Company incurred approximately \$0.4 million in transaction costs related to the acquisition. In connection with this transaction, the Company's assumed \$11.0 million of GEOCAN debt, \$2.2 million of working capital deficiency and paid \$0.5 to cancel GEOCAN's mark to market position on its crude oil hedge. In connection with this acquisition, the Company's credit facility was increased from \$17.25 million to \$55.0 million.

During the year, the Company hedged a portion of its oil production at prices ranging from \$97.55 to \$130.10. At December 31, 2008, the Company realized a gain on these transactions of \$7.4 million and recorded an unrealized gain of \$9.0 million on the outstanding hedges.

In August 2008, the Company spud its first well on its high impact Bakken acreage in Stanley, North Dakota, US. The Company participated for a 35% working interest in the well with a 2,700 meter horizontal lateral. The well was completed and stimulated in early November and was flowing at a rate of 1,200 barrels per day of 42 API oil. The well has stabilized and is currently producing at approximately 300 gross barrels per day with a 1% water cut. The Company has 1,896 net acres of Bakken rights in the Stanley area and is expecting to participate in the drilling of additional wells in the area in 2009.

The Company participated in the drilling of 1 gross (0.25 net) well in the fourth quarter of 2008. In total during 2008, the Company participated in the drilling of 24 gross (18.95 net) wells resulting in 18 gross (13.70 net) oil

wells 1 gross (0.25 net gas wells and 5 gross (5.00 net) dry and abandoned wells. Capital expenditures on drilling, completion and equipping during 2008 totaled \$19.4 million.

Company production for the fourth quarter of 2008 averaged 2,516 Boe per day versus 1,685 Boe per day for the fourth quarter of 2007. For 2008, production averaged 1,980 Boe per day versus 1,709 Boe per day for 2007.

In October, the Company received approval for a normal course issuer bid for the repurchase and cancellation of up to 4,539,307 of its common shares. During Q4, 2008, the Company purchased and cancelled 160,000 common shares at an average price of \$0.195 per share.

Arsenal Energy Inc.'s common shares are listed and posted for trading on the Toronto Stock Exchange under the symbol "AEI" and on the Frankfurt Stock Exchange under the symbol "A1E".

The Company operates in the United States under, Arsenal Energy USA Inc., and produced an average of 401 Boe per day from the US properties for 2008 versus 397 Boe per day in 2007.

OPERATIONAL AND FINANCIAL RESULTS

PRODUCTION, REVENUE AND EXPENSES

Average Daily Production

The Company has production in the provinces of British Columbia, Alberta and Saskatchewan in Canada (80% of total 2008 production) and in the state of North Dakota in the US (20% of total 2008 production). The US production is expected to increase as a percentage of total production as the Company expects to participate in the drilling of additional high impact Bakken oil wells in North Dakota during 2009.

Total Company fourth quarter 2008 production increased 49% to average 2,516 Boe per day up from 1,685 Boe per day in the fourth quarter of 2007. Production increased primarily due to the GEOCAN acquisition. For the year ended December 31, 2008, production increased 16% and averaged 1,980 Boe per day versus 1,709 Boe per day for 2007. 2008 production increased as a result of Arsenal's successful drilling at Evi, Alderson and Galahad and due to the GEOCAN acquisition.

For the year ended December 31, 2008, production of light oil and NGLs comprised approximately 53% of the Company's total production up from 39% of total production for 2007. The Company, due to high average oil prices during 2008, focused on increasing its light oil production base with new drilling in Evi and Galahad targeting light oil. In 2008, the Company allocated little capital to drilling heavy oil or natural gas wells preferring instead to drill for light oil. Heavy oil production declined from 40% of total production in 2007 to 26% of total production in 2008. Natural gas production increased from prior year as a result of the GEOCAN acquisition in Q4 2008 and represents 21% of total production in 2008, the same as in 2007. It is expected that production of heavy oil and natural gas will continue to decline as prices and netbacks for these commodities are not as attractive as for light oil. At present, available capital is being dedicated to the Company's North Dakota Bakken light oil prospect and to Alberta drilling on projects that maximize the Alberta "three point incentive program" announced by the province in March 2009. The Company does not have any current plans to drill heavy oil or natural gas wells until the economics of such drilling improve.

Production Profile and Per Unit Prices

Production

	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Heavy oil (bbl/d)	478	522	(8)	511	691	(26)
Light oil and NGLs (bbl/d)	1,370	777	76	1,048	664	58
Natural gas (mcf/d)	4,003	2,318	73	2,525	2,124	19
Total (boe/d)	2,516	1,685	49	1,980	1,709	16

Production split

Heavy oil	19%	31%	(39)	26%	40%	(36)
Light oil and NGLs	54%	46%	18	53%	39%	36
Natural gas	27%	23%	16	21%	21%	0

The Company's light oil and NGLs production in Canada is now much higher than its heavy oil production. Light oil and NGLs comprise 44% of total Canadian production while heavy oil comprises 32% of total Canadian production. Natural gas contributes 24% to total production in Canada.

Crude oil is sold under 30-day evergreen contracts while natural gas production is sold in the spot market.

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
Prices - Before Derivatives	2008	2007	% Change	2008	2007	% Change
Heavy oil (per barrel)	43.40	63.60	(32)	74.99	54.14	39
Light oil and NGLs (per barrel)	50.07	53.97	(7)	86.23	57.25	51
Natural gas (per mcf)	6.80	6.73	1	7.98	6.50	23
Total (per boe)	46.34	56.95	(19)	75.18	51.10	47

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
Reference Pricing	2008	2007	% Change	2008	2007	% Change
WTI Cushing (\$U.S./bbl)	58.35	90.73	(36)	99.59	72.36	38
Oil Edmonton Light (\$Cdn./bbl)	63.94	87.15	(27)	102.80	77.10	33
Heavy Oil Lloyd blend (\$Cdn./bbl)	47.38	55.39	(14)	82.57	51.92	59
AECO gas (\$Cdn./mcf)	6.16	6.16	-	8.18	6.44	27
NYMEX gas (\$U.S./mmbtu)	6.95	6.96	(0)	9.04	6.84	32
Foreign exchange (\$Cdn./\$U.S.)	1.02	0.98	4	0.95	0.94	1

The average price per Boe received for oil and natural gas peaked during the third quarter of 2008 and has steadily and dramatically declined since then. The Company received an average price during Q4 2008 of \$46.34 per Boe versus \$97.00 per Boe received during Q3 2008 and \$56.95 per Boe received during Q4 2007. On a comparative quarter basis, heavy oil declined 32% while light oil and NGL's declined 7%. The price of natural gas increased 1% over Q4 2007.

For 2008, the average Boe price increased 47% to \$75.18 per Boe versus \$51.10 per Boe for 2007. The average prices received by the Company during 2008 over 2007 average prices reflect the market movement of the various commodities during the year. During 2008, Edmonton light increased 33%, heavy oil Lloyd blend increased 59% and natural gas at AECO increased 27%.

Production by Area

	Three Months Ended December 31					Year Ended December 31				
	2008		2007		% Change	2008		2007		% Change
	Boe/d	% of Total	Boe/d	% of Total		Boe/d	% of Total	Boe/d	% of Total	
Canada										
Maidstone (heavy oil)	105	4	184	11	(43)	167	8	192	11	(13)
Galahad (light oil and solution gas)	85	3	144	9	(41)	235	12	149	9	58
Wildmere (heavy oil)	167	7	114	7	46	127	6	130	8	(3)
Chauvin/Ribstone (GEOCAN)	295	12	-	-	-	74	5	-	-	-
West Current (GEOCAN)	111	4	-	-	-	28	2	-	-	-
Evi (light oil)	134	5	194	12	(31)	260	13	121	7	115
Others	1,177	47	677	40	74	688	35	720	42	(4)
Total Canada	2,074	82	1,313	78	58	1,579	80	1,312	77	20
US										
Stanley (light oil)	191	8	112	7	71	139	7	119	7	16
Lindah (light oil)	74	3	70	4	5	72	4	71	4	2
Tioga (light oil)	12	0	27	2	(55)	45	2	51	3	(12)
Others	164	7	163	10	1	145	7	156	9	(7)
Total US	441	18	372	22	19	401	20	397	23	1
Total boe/d production	2,516	100	1,685	100	49	1,980	100	1,709	100	16

Production Revenue

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Heavy oil	1,909,944	2,468,391	(23)	14,038,290	10,253,445	37
Light oil and NGLs	6,311,089	5,144,621	23	33,066,026	16,576,674	99
Natural gas sales	2,503,882	1,214,871	106	7,375,209	5,043,150	46
Petroleum and natural gas revenue	10,724,915	8,827,883	21	54,479,525	31,873,269	71
Realized hedging gains	8,275,321	-	-	7,424,828	-	-
Unrealized hedging gains	6,595,859	-	-	9,045,804	-	-
Oil and gas revenue after hedging	25,596,095	8,827,883	190	70,950,157	31,873,269	123
Per Boe after realized hedging gains	82.10	56.95	44	85.42	51.10	67
Per Boe after all hedging gains	110.60	56.95	94	97.91	51.10	92

Total oil and gas revenue in Q4 2008 increased 21% to \$10,724,915 from Q4 2007 (\$8,827,882) and decreased 32% from Q3 2008 (\$15,766,815). The Q4 2008 increase from Q4 2007 is due to a 49% increase in average production offset by lower average heavy oil and light oil prices when compared to Q4 2007. The decrease in revenues from Q3 2008 is commodity price related. Production did increase 42% as a result of the GEOCAN acquisition but this increase was not sufficient to offset the significant price reductions realized during Q4 2008.

Oil and gas revenues for 2008 increased 71% to \$54,479,525 as a result of a 47% increase in the average price received per Boe and due to a 16% increase in average production from 2007.

In February 2008, the Company put in place a financial contract covering 200 barrels of oil per day for the period March 1, 2008 to December 31, 2009 at \$97.55 Canadian per barrel. During the period thereafter, the price of WTI increased almost daily. In response to these higher prices, the Company, in late April put another financial hedge in place covering an additional 100 barrels of oil per day for the period June 1, 2008 to December 31, 2009 at \$109.80 Canadian per barrel. In July 2008, as crude prices continued to increase and to lock in a portion of the GEOCAN acquisition metrics, the Company hedged an additional 300 barrels of oil per day for the period August 1, 2008 to July 31, 2009 at \$130.10 Canadian per barrel and 200 barrels of oil per day for the period August 1, 2008 to July 31, 2010 at \$125.80 Canadian per barrel. In late November, the Company hedged 1,000 GJ per day at \$7.46 per GJ for a period of one year commencing January 1, 2009 and in February 2009, entered into another hedge contract for 1,000 GJ per day from January 1, 2010 to December 31, 2010 at \$6.78 per GJ.

As a result of the steady increase in the price of WTI in Canadian dollars from January to July of 2008 and the subsequent drop in the price of WTI in Canadian dollars from August to December, the Company recorded risk management losses on its risk management contracts during the period the price increased and gains on its risk

management contracts when the prices declined. During the fourth quarter of 2008 when prices decreased dramatically, the Company realized \$8,275,321 of risk management gains and \$6,595,859 of unrealized risk management gains on its risk management contracts. On a year to date basis for 2008, because of the decrease in the price of WTI in Canadian dollars and the Company's decision to monetize some of its contracts before maturity, the realized gain for 2008 totaled \$7,424,828. The unrealized gain recorded at December 31, 2008 was \$9,045,804. In January 2009, the Company terminated its crude oil contract for 200 barrels per day at \$97.55 Cdn. realizing a gain on the contract of \$2,055,743.

(\$Cdn.)			Three Months Ended December 31, 2008			Year Ended December 31, 2008			
Hedge Type	Production Per Day	CDN \$ Price	Terminates	Gain (Loss)			Gain (Loss)		
				Realized	Unrealized	Total	Realized	Unrealized	Total
Oil (barrels)	200	97.55	Dec 31, 2009	495,716	3,426,131	3,921,847.00	(521,331)	2,250,440.00	1,729,109
Oil (barrels)	100	109.8	Dec 31, 2009	1,792,432	40,123	1,832,555	1,593,997	0	1,593,997
Oil (barrels)	300	130.1	July 31, 2009	4,971,658	(1,774,685)	3,196,973	5,222,127	0	5,222,127
Oil (barrels)	200	125.8	July 31, 2010	1,015,515	4,503,744	5,519,259	1,130,035	6,394,818	7,524,853
Gas (Gj)	1000	7.46	Dec 31, 2009	-	400,546	400,546	-	400,546	400,546
Gain on commodity contracts				8,275,321	6,595,859	14,871,180	7,424,828	9,045,804	16,470,632

Royalties

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Heavy oil	534,271	346,396	54	2,652,885	2,155,884	23
Light oil and NGLs	1,210,744	1,152,139	5	6,723,484	3,991,795	68
Natural gas sales	438,581	61,406	614	1,515,837	949,128	60
Total royalties	2,183,596	1,559,941	40	10,892,206	7,096,807	53
% of gross oil and gas revenue	20%	18%	15	20%	22%	(10)
Per boe	9.44	10.06	(6)	15.03	11.38	32

During the fourth quarter of 2008, the Company paid \$2,183,596 or 20% of oil and gas revenues in royalties versus \$1,559,941 or 18% in the fourth quarter of 2007. The higher royalty rate is due to expiration of the royalty holiday for which some of the wells drilled in Q3 2007 qualified. For the current quarter, the heavy oil royalty rate was 28%, the light oil and NGL royalty rate averaged 19% and natural gas royalties totaled 18%.

For 2008, the Company paid \$10,892,206 or 20% of oil and gas revenues in royalties versus \$7,096,807 or 22% of oil and gas revenues in 2007. The 2008 royalty rate is 2% lower than the royalty rate experienced in 2007 due to the royalty holiday for which some wells drilled in late 2007 and 2008 qualified. On a Boe basis, royalties increased 32% from \$11.38 per Boe for 2007 to \$15.03 per Boe for 2008 due primarily to higher commodity prices.

For the current year, the heavy oil royalty rate averaged 19%, the light oil and NGL royalty rate averaged 20% and the royalty rate on natural gas averaged 21%. The royalty rate per Boe went up from \$11.38 per Boe in 2007 to \$15.03 per Boe in 2008 due to the increase in oil and natural gas prices. In 2009 as the royalty holiday period on some existing wells expires. As a result, it is expected that the average royalty rate will increase slightly.

In 2008, the Alberta Government announced its New Royalty Framework and subsequent thereto a number of changes and revisions to the New Royalty Framework that took effect January 1, 2009 and a Transitional Royalty Plan. It is not expected that these changes and revisions will have a major effect on the Company's royalties other than to result in some volatility in rates as commodity prices change. A recent announcement by the Alberta Government on a "three point incentive program" to encourage additional drilling reduces royalty rates on new wells drilled to 5% for a period of one year. The Company is reviewing its capital program and is attempting to identify projects that maximize the value of this program to the Company.

Operating Costs

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Heavy oil	1,403,157	754,240	86	5,353,976	5,669,912	(6)
Light oil and NGLs	2,775,926	3,048,121	(9)	7,926,580	7,076,207	12
Natural gas	1,120,571	332,617	237	2,326,020	1,151,413	102
Total operating expenses	5,299,654	4,134,978	28	15,606,576	13,897,532	12
Per boe	22.90	26.67	(14)	21.54	22.28	(3)

Operating costs increased 28% to \$5,299,654 in Q4 2008 from \$4,134,978 in Q4 2007 due to a 49% increase in average production and increased 12% from \$13,897,532 for 2007 to \$15,606,576 for 2008 primarily as a result of a 16% increase in average production and the severity of the cold weather and snowy conditions in Q4 2008. On a Boe basis, operating costs in Q4 2008 were \$22.90 per Boe versus \$18.39 per Boe in Q3 2008 and \$26.67 per Boe in Q4 2007. Operating costs typically increase in Q4 due to the higher cost to produce in colder weather. During the current quarter, the Company added the GEOCAN production base and continued to realize operating cost efficiencies and rationalize properties. For 2008, operating costs averaged \$21.54 versus \$22.28 for the comparable period in 2007. Costs for 2007 included a positive one-time processing adjustment.

Operating costs for 2008 for the Company's operations are higher for heavy oil than light oil by \$7.96 per barrel. For the current year, heavy oil operating costs averaged \$28.60 per barrel versus \$20.67 per barrel for light oil. Heavy oil operating costs are high due to the cost to operate the wells which are almost all single well batteries. This results in high costs for propane, trucking of oil, water and emulsion and ongoing routine maintenance and repairs.

Operating costs for 2008 for natural gas averaged \$2.52 per mcf for the year versus \$1.49 per mcf for the comparable prior period. As noted, 2007 had a one-time positive processing adjustment.

The Company has reviewed and continues to review both its and the GEOCAN operating costs and is implementing initiatives to further reduce operating costs. This review has included the purchase of some properties in order to achieve economies of scale and the sale of other high cost non-core properties over which we have little control. In addition, the Company is examining its field operations and equipment specifications to maximize production and lower costs. The Company, through these initiatives is expecting to further reduce operating cost in 2009.

Operating Netback

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Heavy						
Revenue	43.41	38.47	13	74.99	40.22	86
Royalty	12.14	7.21	68	14.17	8.55	66
Operating	31.89	15.70	103	28.60	22.48	27
Netback per barrel	(0.62)	15.56	104	32.22	9.19	251
Light oil and NGL's						
Revenue	115.72	66.85	73	105.59	62.40	69
Royalty	9.61	16.12	(40)	17.53	16.47	6
Operating	22.02	42.64	(48)	20.67	29.20	(29)
Netback per barrel	84.09	8.09	939	67.38	16.72	303
Gas						
Revenue	6.80	5.06	34	7.98	6.72	19
Royalty	1.19	0.29	314	1.64	1.22	34
Operating	3.04	1.56	95	2.52	1.49	69
Netback per mcf	2.57	3.21	(20)	3.82	4.01	(5)
Boe						
Revenue after hedging	82.10	56.95	44	85.42	51.10	67
Royalty	9.44	10.06	(6)	15.03	11.38	32
Operating	22.90	26.67	(14)	21.54	22.28	(3)
Netback per Boe after realized hedging	49.76	20.21	146	48.86	17.44	180

The operating netback (after realized hedging gains) realized was \$49.76 per Boe for Q4 2008 and \$48.86 per Boe for 2008 versus \$20.21 per Boe for the fourth quarter of 2007 and \$17.44 per Boe for 2007. The Q4 2008 and 2008 operating netbacks reflect significant hedging gains for light oil and the 2008 netback reflects higher commodity prices.

Increased oil and natural gas prices, realized hedging gains and slightly lower operating costs were responsible for the increased netback in 2008. On an individual product basis, the net back for heavy oil was \$32.22 versus \$9.19 for 2007 due to higher average prices, for light crude the netback was \$67.38 versus \$16.72 for 2007 due to higher prices and realized hedge gains and for natural gas the netback was \$3.82 versus \$4.01 for 2007 lower as higher prices were offset by higher operating costs and higher royalties.

General and Administrative

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Gross expenditures	1,622,206	1,782,859	(9)	5,332,498	5,232,549	2
Overhead recovery	(118,065)	(110,830)	7	(475,675)	(435,049)	9
Capitalized overhead	(73,250)	(31,774)	131	(273,250)	(689,002)	(60)
Net general and administrative expense	1,430,891	1,640,255	(13)	4,583,573	4,108,498	12
Net general and administrative per boe	6.18	10.58	(42)	6.33	6.59	(4)

For Q4 2008, gross general and administrative expenditures decreased 9% to total \$1,622,206 when compared to \$1,782,859 for Q4 2007. On a net basis, costs were also lower by 13% to total \$1,430,891 for the current quarter. On a Boe basis, the Company reduced costs for the quarter from \$10.58 per Boe in 2007 to \$6.18 per Boe in 2008.

During the current quarter, the Company experienced higher one-time costs for the set-up and integration of GEOCAN, costs related to the evaluation, documentation and testing of its internal control system as required

under National Instrument 51-109 and higher costs for office rent, office its move and supplies. In addition, the Company experienced higher costs related to its engineering evaluation but experienced lower cost for legal and audit fees.

For 2008, gross general and administrative expenditures increased 2% to total \$5,332,498 for the current year when compared to \$5,232,549 for 2007. On a net basis, costs increased 12% to \$4,583,573 for 2008. On a Boe basis, costs were lowered to \$6.33 per Boe for 2008 versus \$6.59 for 2007. For 2008, in addition to the Q4 2008 one-time costs outlined above, the Company experienced increased costs for consulting fees for tax, audit and reservoir.

Overhead recovery increased in the current quarter to \$118,065 from \$110,830 in Q4 2007 and to \$475,675 in 2008 versus \$435,049 in 2007. Additional Company operated well overhead charges were primarily responsible for this increase.

The Company capitalizes overhead directly related to exploration and development. For Q4 2008, capitalized overhead totaled \$73,250 and for 2008 capitalized \$273,250. In 2007, the Company capitalized overhead charges related to its activity in Egypt.

The Company has adopted a strict and rigid approach to general and administrative expenditures in 2009. Employee raises and bonuses have been deferred and all expenditures are under close scrutiny. The objective is to further reduce these costs in 2009.

Interest Expense

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Bank line interest	(1,035,543)	1,821,552	(157)	(693,764)	2,941,047	(124)
Per boe	(4.47)	11.75	(138)	(0.96)	4.71	(120)

In Q4 2007, Canada Revenue Agency ("CRA") conducted an audit on the 2003, 2004 and 2005 flow-through share offerings of a previously acquired company. CRA had proposed to reduce the amount claimed as Qualifying Expenditures and to reassess the Part XII.6 tax due under the look-back rule. 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 in Q4 2007 a liability of \$1,300,000 for the income tax assessed the subscribers for the shortfall in Qualifying Expenditures and \$424,061 in additional Part XII.6 tax. Interest expense in the period was increased by the total - \$1,724,061 to total \$2,941,047 for 2007.

In Q4 of 2008, the Company and Canada Revenue Agency ("CRA") completed their review and discussions on the audit and the Qualifying Expenditures and the related Part XII.6 tax and reached agreement that resulted in the above amount being substantially reversed. This reversal has resulted in a current year credit to interest expense totaling \$693,764. The amount represents interest paid on the Company's line of credit of \$795,667, current year Part XII.6 tax of \$28,462 and miscellaneous interest charges of \$1,446 offset by the above noted reversal of \$1,519,462.

Interest is paid on the Company's revolving demand loan at a 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.

During Q4 2008, most of the Company's borrowings were based on a rate of prime plus 0.25% for prime based loans and on a rate for guaranteed notes of the guaranteed note base rate plus 1.50%. Borrowing under the facility increased in Q4 2008 due to the acquisition of GEOCAN and averaged approximately \$44.3 million for the quarter versus approximately \$9.1 million during the fourth quarter of 2007. The Company's Q4 borrowings were done under the guarantee note facility.

The draw on credit facility increased from its December 31, 2007 balance of \$8.9 million to a high of \$15.2 million in mid-March 2008 declining to a low of approximately \$5.0 million in late July. Strong commodity prices, particularly for crude allowed the Company to reduce the average borrowing on the facility. During the fourth quarter, the facility was increased to fund the GEOCAN acquisition with the facility peaking at \$50.9 million in late October.

Interest and fees paid on the Company's line of credit that averaged approximately \$17.6 million for the year (\$13.3 million for 2007) decreased 17% to \$795,667 for 2008 (\$959,818 for 2007) primarily as a result of lower interest rates year over year and due to the Company meeting its bank covenants during the year and thus paying no additional bank fees.

Interest on Convertible Debentures

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Interest on debentures	69,789	70,172	(1)	278,400	278,400	-
Per boe	0.30	0.45	(33)	0.38	0.45	(14)

The Company pays interest at 8% per annum on the \$3,480,000 of convertible debentures acquired in the Tiverton acquisition. Interest is paid semi-annually on June 30 and December 31 and totaled \$69,789 for Q4 2008 and \$278,400 for the year ended December 31, 2008.

For the quarter ended December 31, 2008, the Company recorded \$33,559 (\$123,049 in total for 2008) of accretion expense relating to the amortization of the discount of the debenture. (See "Convertible Debenture" below).

The debentures were redeemed on February 15, 2009.

Other Expenses

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Other expenses	-	-	-	438,056	-	-
Per boe	-	-	-	0.60	-	-

Other expense incurred during 2008 includes the forgiveness for past services rendered of a \$225,000 loan (to purchase shares of the Company) made to a former officer and director and expenses relating to the settlement of certain asset retirement obligations assumed from a prior corporate acquisition.

Depletion Depreciation and Accretion

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Depletion, depreciation and accretion	7,030,243	3,354,382	110	18,477,726	16,756,827	10
Per boe	30.38	21.64	40	25.50	26.86	(5)

Depletion, depreciation and accretion for the current quarter totaled \$7,030,243 an increase of 110% from \$3,354,382 for Q4 2007. This increase results from a 49% increase in production in 2008 over 2007 and from a higher rate per Boe due to the GEOCAN acquisition in October 2008. On a Boe basis the rate increased to \$30.38 per Boe versus \$21.64 per Boe for Q4 2007. The increase per Boe for Q4 2008 results primarily from the acquisition of GEOCAN. Based on the purchase price allocation of approximately \$59.5 million to property plant and equipment and proved reserves of 1.7 million Boe, the depletion and depreciation rate for the GEOCAN purchase is \$35.00 per Boe. The Company expects to convert some of the GEOCAN probable reserves to proven once prices recover through additional drilling.

For the year ended December 31, 2008, depreciation, depletion and accretion increased 10% to total \$18,477,726 or \$25.50 per Boe versus \$16,756,827 or \$26.86 per Boe for the comparable 2007 period. During the year, average production increased 16%. Reduced per unit charges for depletion, depreciation and accretion are reflective of the addition of proved reserves to the Company's reserve base at lower costs than in prior years. With the GEOCAN acquisition, the rate per Boe is expected to increase in 2009.

Property Impairment

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Property impairment	-	2,370,218	(100)	495,650	12,465,675	(96)
Per boe	-	15.29	(100)	0.68	19.98	(97)

During Q2 2007, the Company recorded ceiling test impairment on its Canadian cost centre of \$3,249,288.

In late 2007, Arsenal made a decision to seek strategic alternatives for its concession in Egypt. During the first quarter of 2008, the Company sought professional assistance in evaluating various alternatives including further participation in the upcoming drilling as well as the sale of its entire interest. As a result of the process, the Company did not receive any bids for the assets and determined that the project did not warrant additional drilling as the chances of success were low. As a result of this process, in the first quarter of 2008, the Company wrote off the remaining carrying amount of its Egypt property, recording a property impairment of \$495,650. During 2007, as a result of drilling two dry holes, the Company wrote down the carrying amount of its Egypt property by \$7,269,099. In the second quarter of 2008, the Company gave notice effective June 30, 2008, that it was withdrawing from further participation in the Egypt concession.

Goodwill

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Goodwill impairment	-	-	-	-	4,791,561	(100)

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the fair value of the net identifiable assets and liabilities of the acquired business. Goodwill is stated at cost and is not amortized. The goodwill balance is assessed for impairment each year end or more frequently if events or changes in circumstances indicate that the asset may be impaired. The test for impairment is conducted by comparing the book value to the fair value of the reporting entity. Impairment is charged to income in the period it occurs.

In Q1 2007, the Company compared the deemed fair value of goodwill to the carrying amount of goodwill. As a result of this test, the Company wrote off \$4,791,561 in goodwill in the first quarter of 2007.

Stock-based Compensation

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Compensation expense	286,530	(34,731)	925	824,263	704,811	17

The Company accounts for its stock-based compensation program using the fair-value method. Under this method, compensation expense related to this program is recorded in the statement of operations over the vesting period of the options.

In 2008, the Company granted 1,296,000 options at \$0.60 per share to officers and employees, 300,000 options at \$0.62 to an officer and 450,000 options at \$0.79 to directors, 250,000 options at \$0.82 per share to an employee, 300,000 options at \$0.71 per share to an officer and 1,700,000 options at \$0.375 per share to directors, officers

and employees. These options vest over periods ranging from eighteen months to three years. In 2008, 283,251 options were exercised at a weighted average price of \$0.32 per share for proceeds of \$90,217. During the year, 410,668 options issued at a weighted average price of \$1.01 were forfeited.

Stock-based compensation expense for the quarter and year ended December 31, 2008 totaled \$286,530 and \$824,263 respectively versus a credit of \$34,731 and \$704,811 for the comparable quarter and year in 2007. The change for the comparative quarter and for the year, results from the timing and valuation of options issued and from options having reached the end of their vesting period.

During the fourth quarter of 2008 the Company capitalized \$49,481 of stock based compensation to property plant and equipment bringing the year to date total to \$140,344.

In January 2009, the Company issued 1,688,000 stock options to employees, officers and directors at \$0.205 per share.

Income Taxes

(\$Cdn.)	Three Months Ended December 31			Year Ended December 31		
	2008	2007	% Change	2008	2007	% Change
Current income tax expense (recovery)	(258,981)	(253,298)	2	(258,981)	272,262	(195)
Future income taxes (reduction)	4,161,390	(2,666,575)	(256)	6,013,926	(7,443,926)	(181)
	3,902,409	(2,919,873)	(234)	5,754,945	(7,171,664)	(180)

The Company recorded an income tax provision of \$4,161,390 in Q4 2008, increasing the future income tax expense provision to \$6,013,926. Higher average commodity prices in 2008 and realized and unrealized commodity contract gains were primarily responsible for the provision in 2008. In 2007, for both Q4 and for the year, the Company recorded a recovery based on the Company incurring significant accounting losses due to ceiling test and property impairment, low operating netbacks and high general and administrative and interest expenses.

In the US during Q4 2008, the Company recorded income tax recovery of \$258,981. The Company experienced a write off of a significant receivable account during the year negating the benefit of higher commodity prices and significant realized and unrealized commodity contract gains. The Company was taxable in 2007.

Arsenal does not expect to pay current tax in Canada during 2009 based on existing tax pools available to offset realized commodity contract gains, planned expenditures and current commodity prices. It may however be taxable in 2009 depending on capital expenditures and commodity prices.

In the US, due to the realization of a significant gain on the monetizing of a commodity contract and due to increasing production, the Company may be taxable in 2009. Efforts are underway to minimize the tax impact on the Company's operations.

As a result of a portion of the unrealized commodity contract gains being current, the Company has recorded under current liabilities future income taxes of \$2,202,600. Of this, \$900,000 relates to the tax on the unrealized gain on the US commodity contract of \$2,250,440 and the remainder \$1,302,600 relates to the unrealized gain on the commodity contracts on Canadian production of \$6,795,364.

OUTLOOK

2008 ended in what some describe as a global economic crisis with access to equity markets virtually non-existent, significant limitations on credit and unprecedented declines in commodity prices and stock exchange indexes. The crisis continues today and it appears that we are in the midst of a world-wide recession. Crude oil prices declined significantly from a monthly average peak of \$133.63 (WTI Cushing, Oklahoma \$US/barrel) in June 2008 to a December monthly average of \$41.44 per barrel, the lowest price in years. Prices to date in 2009 hover slightly

higher than the December average price and the outlook for recovery are dependent on economic activity increasing demand. Natural gas prices have shown a similar trend peaking in July at \$11.08 (Alberta daily spot AECO c) per GJ and declining to average \$6.12 per GJ in December 2008. Since December 2008, natural gas prices have declined and are trading in the \$4.00 - \$4.25 per GJ range for 2009. In addition to the decline in commodity prices, the new Alberta royalty regime came into effect on January 1, 2009 and negatively impacted some of the Company's drilling plans. Recent initiatives by the Alberta government are expected to spur activity and appear to benefit some of the Company's exploration and development projects.

Arsenal is an oil levered company. During 2008 when crude prices increased, Arsenal produced record revenues and cash flow. With the price of crude declining during Q4 2008 and into 2009, the Company is experiencing reduced revenues and cash flow. In response to the expected decline in revenues and cash flow, the Company has cut its capital expenditure program to only required expenditures, shut-in wells that are uneconomic at current prices, deferred remedial operations required to bring production back on-stream where the payout is longer than one year, deferred salary increases and bonuses and commenced a review of all other expenditures. Our objective is to weather the current downturn and defer projects until economic conditions improve. We are not prepared to deplete our current inventory of projects at current commodity prices. We intend to precede cautiously using cash flow on only high quality projects and to reduce debt.

In October 2008, Arsenal acquired all of the outstanding common shares of GEOCAN for \$30.0 million cash, and the issuance of 10,623,498 Arsenal shares. The Company also assumed \$11.0 million of GEOCAN debt, \$2.2 million in working capital deficiency and paid \$0.5 million to cancel GEOCAN's mark to market position on its crude oil hedge. In connection with this transaction, the Company's credit facility was increased from \$17.25 million to \$55.0 million.

The acquisition added approximately 800 Boe/d to the Company's production base effective October 8, 2008.

The combination of the two corporations has the following benefits:

- The increased size of the combined corporation will contribute to lower average operating expenses and cost of capital, overhead synergies and higher financial leverage;
- The combined corporation will have a complimentary fit of assets as approximately 40% of GEOCAN's current production is in Arsenal's core east central Alberta area; and
- The addition of GEOCAN's core Northeast British Columbia property, where approximately 40% of GEOCAN's current production is located, to the combined corporation will provide a further core property for development. The Company will also acquire new exploration plays in Ochre and Tomahawk as well as 82,000 net acres of undeveloped land, providing additional potential upside to the combined corporation's shareholders.

It is expected that when commodity prices return to more acceptable levels, Arsenal will be in position to realized additional benefits (through drilling) from the GEOCAN acquisition.

During 2008, in order to lock-in a portion of the combined Company's future expected funds from operations for the remainder of 2008, and for 2009 and 2010 to continue its exploration and development program and as a result of the GEOCAN acquisition, the Company had under taken to hedge a portion of its future crude oil production. At September 30, 2008, the Company had 800 barrels per day hedged at a weighted average price of approximately \$117.73 Cdn. per barrel. During Q4 2008, the Company collapsed two of these hedges receiving total proceeds of approximately \$5.5 million. Proceeds were used to reduce debt. At December 31, 2008, the Company had remaining crude hedges totalling 400 Boe/d of oil production at an average price of approximately \$114.85 Cdn. One of these hedges was collapsed in January generating proceeds of approximately \$1.8 million. The remaining hedge of 200 barrels per day at \$125.80 Cdn. until July 31, 2010 is expected to be monetized with proceeds used to further reduce debt.

The Company exited 2008 with net debt at \$48.5 million (\$41.8 million net of the Company's current mark to market unrealized hedge position) and a credit facility of \$55.0 million. Despite a year over year increase in reserves (as a result of successful drilling) over and above production, the significant decline in commodity prices over the latter part of 2008 and into 2009 will reduce the Company's credit facility. In order to ensure that the Company remains within its authorized credit limits, capital expenditures have been highly scrutinized and in cases, curtailed, operating and general and administrative costs have been reduced and our remaining crude hedge will be monetized. In addition, non-core properties are being sold and any excess cash flow is being dedicated to debt reduction.

Arsenal's revenue and cash flow for 2009 is highly dependent on the price of crude. As prices decline, our margins decline accordingly. Our 2009 budget has been a moving target with revisions, due to the fluctuating commodity prices, done almost weekly. Arsenal has reigned in spending and is not committing to expenditures that are not absolutely required to retain our interest or that do not result in near immediate cash flow benefits. We estimate our breakeven position based on our mix of production at approximately \$35.00 WTI per barrel with Canadian dollar assumed to trade at \$0.80 US.

At December 31, 2008, Arsenal had total bank debt and working capital deficiency of \$48.5 million (including \$3.5 million of convertible debentures but excluding \$6.7 million of current risk management asset and \$2.2 million of current future income tax liability) on a \$55.0 million bank facility. The capital expenditure program for 2008 of \$22.5 million was very successful adding both reserves and replacing production. In addition, the acquisition of GEOCAN has added reserves and extended the Company's reserve life. The 2008 capital expenditure program was funded from funds from operations for 2008, and from the private placement of flow-through shares completed in March and April of 2008.

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.

Cash flow for 2009 (including expected realized hedging gains) is expected to be between approximately \$18.0 million and \$20.0 million. This projection is based on expected 2009 average production of approximately 2,200 Boe per day using the current 2009 WTI strip price of approximately \$47.75 US per barrel and a Canadian US exchange rate of \$0.79. Arsenal's mix of oil (75%) and gas (25%) is expected to generate revenue of approximately \$43.45 per Boe before any adjustments to revenue for hedging activities.

Capital expenditures for 2009 are expected to total between \$11.0 million and \$13.0 million and will depend to some degree on the number of wells drill in North Dakota and on Alberta drilling under the "three point incentive program". As a result, debt is expected to reduce slightly from the current level to between \$38.0 million and \$40.0 million at 2009 year end. Due to the deterioration in financial markets, no additional equity is expected to be issued in 2009.

While commodity prices have gone through a major correction in the past few months, the impact of the recently announced Alberta royalty incentives is expected to be favourable in some circumstances. With this incentive, and based on current prices for crude oil the Company has projects attractive enough to meet our economic threshold. Arsenal's management believes with Arsenal's inventory of projects and drilling locations, the Company can continue to grow through its selective exploration program in this current commodity environment. The additional production volumes from GEOCAN and from wells being brought on-stream in Q4 2008, and the crude oil hedges should offset to some degree the cash flow reduction from lower prices. Production in 2009 will be positively impacted by the tie-in of the Galahad wells (fall of 2009), production from the Stanley Bakken wells, and from an extensive work over program that has commenced on both Arsenal and GEOCAN properties. The Company has been undertaking a property rationalization process, sold some non-core properties in 2008 and is hoping to sell additional non-core properties in 2009 in order to lower debt and to concentrate the Company's effort on core properties.

Summary of Quarterly Results

(\$Cdn.)	2008				2007			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Oil and gas revenue	10,724,915	15,766,815	16,678,644	11,309,151	8,827,883	7,568,644	7,702,380	7,774,362
Net income (loss)	6,974,803	10,028,193	(1,925,853)	(488,026)	(2,944,193)	(3,029,332)	(9,406,449)	(7,999,026)
Per share - basic	0.08	0.11	(0.02)	(0.01)	(0.04)	(0.04)	(0.13)	(0.11)
Per share - diluted	0.08	0.11	(0.02)	(0.01)	(0.04)	(0.04)	(0.13)	(0.11)
Funds from operations	11,316,461	8,093,159	8,083,001	3,798,146	134,648	900,028	1,078,581	1,842,009
Per share - basic	0.12	0.09	0.09	0.05	-	0.01	0.01	0.03
Per share - diluted	0.12	0.09	0.09	0.05	-	0.01	0.01	0.03
Total assets	143,723,628	78,546,339	71,112,441	71,113,137	65,097,042	62,288,632	63,745,799	86,839,591
Total debt (1)	48,479,097	13,384,766	14,266,269	15,344,257	17,391,760	14,128,455	10,628,558	20,341,897
Shares outstanding	101,249,646	90,786,148	90,719,815	89,181,542	83,698,042	73,917,173	73,917,173	73,642,173

(1) Includes convertible debentures due February 2009 but excludes risk management contracts and future income taxes whether current or long term

Arsenal's quarterly results have fluctuated significantly in the past eight quarters due to production increases, some significant one-time items like tax audits being recorded and then reversed, ceiling test write-downs and recognition of impairment of properties and goodwill. More recently, commodity prices have been very volatile and have been responsible for wide swings in operating income and the Company's hedges have, during the past year, resulted in significant realized and unrealized losses and then reversing, due to the reduction in commodity prices, to realized and unrealized gains. For Arsenal, quarterly results will fluctuate and depend on the movement in commodity prices and the differentials in heavy oil. The Company expects that its recent acquisition coupled with improved operational efficiencies will lead to more comparative and stable results going forward.

Contractual Obligations

In the ordinary course of business, the Company enters into various contractual obligations, including the following:

- purchase of services
- royalty agreements
- operating agreements
- processing and treating agreements
- right-of-way and road use agreements
- lease obligations for office space
- flow-through share agreements

All such contractual obligations reflect market conditions at the time of contract and do not involve related parties.

Obligations with a fixed term are as follows:

(\$Cdn.)	2009	2010	2011	2012	2013
Demand operating loan	42,002,399				
Lease of office premises	632,192	632,192	632,192	368,779	-
Flow-through share obligations	3,900,000	-	-	-	-
Total	46,534,591	632,192	632,192	368,779	-

Summary of Annual Results

	2008	2007	2006
FINANCIAL			
Oil and gas revenues	54,479,525	31,873,269	30,820,734
Funds from operations	31,290,767	2,976,456	7,817,054
Per share - basic	0.35	0.04	0.13
- diluted	0.35	0.04	0.12
Net income (loss)	14,589,117	(23,379,000)	(27,056,421)
Per share - basic	0.16	(0.31)	(0.44)
- diluted	0.16	(0.31)	(0.44)
Total debt (excluding derivatives and tax)	48,479,492	20,731,800	22,448,190
Corporate acquisition	30,420,000	-	38,914,366
Capital expenditures	21,336,860	20,823,716	24,010,422
Property acquisitions	728,012	575,000	-
Property dispositions	2,863,999	15,491,355	-
Shares outstanding - end of period	101,249,646	83,698,042	73,642,173
OPERATIONS			
Daily average production (boe)	1,980	1,709	1,913
Operating netback (per boe)	48.86	17.44	19.99

Summary of Annual Results by Country

Year Ended December 31, 2008

	Canada	United States	Egypt	Corporate	Total Company
Revenue					
Oil and gas	42,496,396	11,983,129	-	-	54,479,525
Realized (loss) on commodity contracts	7,946,159	(521,331)	-	-	7,424,828
Unrealized gain on commodity contracts	6,795,364	2,250,440	-	-	9,045,804
	<u>57,237,919</u>	<u>13,712,238</u>	<u>-</u>	<u>-</u>	<u>70,950,157</u>
Royalties	(6,776,559)	(4,115,647)	-	-	(10,892,206)
	<u>50,461,360</u>	<u>9,596,591</u>	<u>-</u>	<u>-</u>	<u>60,057,951</u>
Other income	4	7,476	-	-	7,480
	<u>50,461,364</u>	<u>9,604,067</u>	<u>-</u>	<u>-</u>	<u>60,065,431</u>
Expenses					
Operating	12,412,944	3,193,632	-	-	15,606,576
General and administrative	3,228,530	1,115,980	239,063	-	4,583,573
Financing charges (recovery)	(693,764)	-	-	-	(693,764)
Interest on convertible debentures	278,400	-	-	-	278,400
Other expenses	371,173	66,883	-	-	438,056
Foreign exchange gain (loss)	(972,757)	564,655	(4,118)	-	(412,220)
Convertible debenture accretion	123,049	-	-	-	123,049
Depletion, depreciation, and accretion	17,664,190	808,534	5,002	-	18,477,726
Property, plant and equipment impairment	-	-	495,650	-	495,650
Stock-based compensation	824,263	-	-	-	824,263
	<u>33,236,028</u>	<u>5,749,684</u>	<u>735,597</u>	<u>-</u>	<u>39,721,309</u>
Income (loss) before taxes	17,225,336	3,854,383	(735,597)	-	20,344,122
Income taxes					-
Current income tax expense (recovery)	-	-	-	(258,981)	(258,981)
Future income tax expense (reduction)	-	-	-	6,013,926	6,013,926
	<u>-</u>	<u>-</u>	<u>-</u>	<u>5,754,945</u>	<u>5,754,945</u>
Net Income (loss) for the year	17,225,336	3,854,383	(735,597)	(5,754,945)	14,589,177

Bank Debt, Liquidity and Capital Resources

Capital Management

In order to continue the Company's ongoing 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 is committed to establishing and maintaining a strong capital base to ensure the Company has access to 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 as components of its capital base. Arsenal's convertible debentures are due in February of 2009 and therefore have become a consideration in the Company's management 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 debt to annualized funds flow ratio and its debt to equity ratios. Debt includes bank debt and convertible debentures, plus or minus working capital. Annualized funds flow is calculated as cash flow from operations before changes in non-cash working capital and asset retirement expenditures from the Company's most recent quarter multiplied by four adjusted, if required by increasing or decreasing commodity price expectations. The Company's strategy is to maintain this ratio at 1 : 1. This ratio may increase or decrease somewhat depending on the timing and nature of the Company's activities and commodity prices. During periods of high drilling activity and after large property or corporate acquisitions, it is expected that the ratio would increase and during periods of high commodity prices, the ratio would decrease. The Company's focus in these instances is to concentrate on bringing the ratio back into line. The Company prepares an annual operating and capital expenditure budget. The budget is updated when critical factors change and actual results are realized. Critical 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 drilling results and production profiles. The Company's board of directors approves the budget and changes thereto.

At December 31, 2008, the Company's debt (excluding the Company's current risk management liability and current future income taxes) to funds flow (Q4 2008 annualized) was 1.07: 1 and its debt to equity ratio was 0.75: 1, both within established guidelines. The debt to forward cash flow ratio at December 31, 2008 is not expected to be within the ratio of 1: 1 as established in the management strategy guidelines by the end of Q1 2009. Due to the significant and continuing deterioration of commodity prices, the impact of these declines on future cash flows and the potential reduction in the Company's lending base, the Company may have a reduction in the current credit facility. Plans, including the sale of non-core properties, additional hedging and the deferral of exploration are currently being developed to deal with this issue.

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 to below 1 : 1.

At December 31, 2008, the Company is in compliance with this covenant.

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 period.

Demand Operating Loan Facility

At December 31, 2008, the Company had a demand operating loan facility in the amount of \$55.0 million. Debt under the facility, which includes bank debt, working capital deficiency and the convertible debentures but excludes the current risk management contracts and future income tax (whether assets or liabilities) amounted to \$48.5 million at December 31, 2008.

The facility can be utilized in either Canadian or US dollars, bears interest at Canadian or US bank prime plus 0.10%, increasing to Canadian or US bank prime plus 1.00% if net debt to trailing funds flow (funds flow for the last quarter annualized) exceeds 2.50: 1. 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, a continuing guarantee from the Company's US subsidiary in the form of a Mortgage Security Agreement and Letter of Undertaking limited to \$13,000,000.

The Company is in compliance with its bank covenants at December 31, 2008.

With the decline in petroleum and natural gas prices since the Company's last engineering evaluation, it is expected that the lending value of the Company's reserves will also decline. The Company expects the operating

loan facility to be reduced. During 2008, in anticipation of the reduction of the facility, the Company crystallized three of the four hedges put in-place during 2008 and is considering crystallizing the remaining hedge in Q1 2009. In addition, the Company has taken natural gas hedges for the period January 1, 2009 to December 31, 2009 at \$7.46 per GJ and one for the period January 1, 2010 to December 31, 2010 at \$6.786 per GJ.

Convertible Debenture

The Company, as part of the Tiverton acquisition in 2006, assumed the obligations under \$3,480,000 face value of convertible debentures. 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, calculated at \$370,000, represents the holder's conversion right and was included in Shareholders' Equity. The remaining balance being \$3,110,000 was classified as debt and is being accreted over the remaining period to maturity.

Interest accrues on the debentures at 8% payable semi-annually on June 30th and December 31st of each year. The debentures will mature on February 15, 2009 unless called for redemption earlier by Arsenal. The debentures are convertible by the holders at any time prior to maturity into 1,539,170 shares of the Company, representing a conversion price of \$2.26 per Arsenal share.

The Company can elect to prepay the debenture providing the Company's shares trade above \$2.60 per share for 22 consecutive days. If the holder exercises the conversion right, they will receive accrued and unpaid interest up to and including the conversion date.

The Company redeemed the convertible debentures on February 15, 2009 from funds available on its currently available line of credit.

Liquidity

The sudden and severe decline in commodity prices and the limited access to equity markets have affected management's approach and operating strategy of the Company. As noted, it is expected that the Company's Demand Operating Loan Facility may be reduced as future cash from operations is reduced due to lower expected prices. At current commodity prices, the Company will generate excess cash from operations. This excess cash will, depending on various factors, need to be allocated to debt reduction and capital programs.

The Company believes it will have the financial resources necessary to both reduce debt to an acceptable level and to complete its 2009 proposed capital program. In the event that commodity prices, interest or exchange rates, or other factors negatively impact funds flow from operations, the Company would plan to reduce the proposed 2009 capital program so that the Company's debt stays within its expected credit facilities.

In order to ensure that funds were available for its 2009 capital program, the Company has in-place certain commodity hedges. These hedges may remain in place and consideration is being given to putting additional hedges in-place.

Share Capital

At December 31, 2008, the Company has 101,249,646 common shares and 7,361,000 options outstanding. No common shares have been issued since year end. In January 2009, the Company issued 1,688,000 options at \$0.205 to directors, officers and employees bringing the total options currently outstanding to 9,049,000.

In October 2008, the Company issued 10,623,498 common shares at \$0.795 per share as part of the consideration for the acquisition of GEOCAN.

In June 2008, pursuant to past services rendered as an officer and the agreed resignation as a director of the Company, a loan granted in a previous year, provided to purchase 225,000 common shares of the Company, in the amount of \$225,000 was forgiven.

In April 2008, the Company completed a private placement, commenced in the first quarter of 2008, raising total gross proceeds of \$4,787,059. In total, the Company issued 1,249,300 common shares at \$0.63 per share for gross proceeds (before commission and expenses) of \$787,059 and 5,555,555 flow-through shares at \$0.72 per share for gross proceeds (before commission and expenses) of \$4,000,000. An officer of the Company subscribed for 289,500 common shares for gross proceeds of \$182,385 and officers subscribed for 34,000 flow-through shares for gross proceeds of \$24,480.

The terms of the flow-through share issue require the Company to renounce to subscribers Canadian Exploration Expenditures in the amount of \$4,000,000 effective December 31, 2008. The expenditures are to be incurred prior to December 31, 2009. To December 31, 2008, the Company had incurred approximately \$100,000 of eligible expenditures.

Arsenal's 7,361,000 options outstanding have a weighted average exercise price of \$0.70. At December 31, 2008, 3,962,334 options were exercisable at a weighted average price of \$0.86 per share.

During 2008, 4,296,000 options were granted at a weighted exercise price of \$0.55 per share, 283,251 options were exercised at an exercise price of \$0.32 per share and 410,668 options at a weighted average exercise price of \$1.01 expired.

The following table outlines the common share issues and option exercises during the period:

Common shares	Year Ended December 31		Year Ended December 31	
	Shares	Amount (\$)	Shares	Amount (\$)
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
Allocated from contributed surplus	-	60,490	-	-
Private placement of common shares	1,249,300	787,059	-	-
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
Forgiveness of loan	-	225,000	-	-
Normal course issuer bid	(160,000)	(147,863)	-	-
Shares held in escrow	-	-	-	(225,000)
Balance - end of year	101,249,646	93,515,925	83,698,042	81,676,603

In October 2008, the Company announced approval to purchase up to 4,539,307 of its common shares by way of a normal course issuer bid (NCIB) through the facilities of the Toronto Stock Exchange. The 4,539,307 shares represent approximately 4.5% of the 101,249,646 currently issued and outstanding common shares of the Corporation. In accordance with the rules of the Toronto Stock Exchange ("TSX") the daily repurchase limit under the NCIB is 40,463 shares. In November 2008, the TSX increased that daily limit to 80,926 until March 31, 2009. The purchases may commence on October 16, 2008 and will terminate on October 15, 2009, or on such earlier date as the Corporation may complete its purchases pursuant to a notice of intention to be filed with the Toronto Stock Exchange or provide notice of termination. Purchases will be made by Arsenal in accordance with applicable regulatory requirements and the price which Arsenal will pay for any such common shares will be the market price of such shares at the time of acquisition. To December 31, 2008, the Company had purchased and cancelled 160,000 at an average price of \$0.195 per share

Related Party Transactions

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 for legal fees and disbursements.

In 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 purchasing 34,000 flow-through shares at \$0.72 per share and 289,500 common shares at \$0.63 per share.

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.

Capital Expenditures

(\$ Cdn.)	2008	2007
Property acquisitions	728,012	575,000
Property dispositions	2,863,999	15,491,355
Land	707,463	1,192,961
Seismic	856,957	999,408
Drilling and completions	15,476,028	13,349,402
Capitalized general and administrative	472,321	435,049
Production equipment, facilities and tie-ins	3,964,120	4,586,233
Other	5,842,714	1,889,743
Total capital	27,319,603	22,452,796
Non-cash additions	(5,982,743)	(1,629,080)
Cash capital expenditures	21,336,860	20,823,716

During 2008, the Company participated in the drilling of 24 gross (18.95 net) wells resulting in 18 gross (13.70 net) oil wells 1 gross (0.25 net) gas wells and 5 gross (5.00 net) dry and abandoned wells. Of the 24 wells drilled to date, 23 have been drilled in Canada and one in the US.

Capital expenditures for Q4 2008 totaled \$4,126,121 lower than in previous quarters as the Company reduced its spending in response to lower commodity prices and restricted capital market and credit availability.

For 2008, total capital additions were \$27,219,603 of which \$21,336,860 were cash and \$5,982,743 were non cash additions. Non cash additions included asset retirement costs on wells drilled or purchased and capitalized stock based compensation.

During 2008, the Company acquired GEOCAN and added to its interest at Wildmere and sold non-core properties at Alderson, Ansell and Ochre. None of the sold properties had any production. All properties were in Alberta.

Commitments and Contingencies

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 and legal counsel, the outcome of the lawsuits, now pending, is not determinable or not material to the Company's operations. Should any loss result from the resolution of these claims, such loss will be charged to operations in the year of resolution.

Risk Management

Commodity price risk

Commodity price risk is defined as fluctuations in crude oil, natural gas, and natural gas liquid prices. The Company uses derivative instruments as part of its risk management approach to manage commodity price fluctuations and stabilize cash flows available for future development programs. The Company does not enter into derivative contracts for speculative purposes. During 2008, the Company entered into four crude oil derivative contracts and natural gas derivative contract. These contracts and the realized and unrealized gain or loss for 2008 are summarized below:

(\$Cdn.)

Hedge Type	Production Per Day	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	0	400,546	400,546
Gain on commodity contracts				7,424,828	\$ 9,045,804	\$ 16,470,632

The Company did not make use of any derivative contracts in 2007.

Production risk

Production risk relates to the Company's ability to produce, process and transport crude oil and natural gas. To manage this risk to an acceptable level, the Company performs regular and proactive maintenance on its wells, facilities and pipelines. The Company operates approximately 80% of its production, which affords greater control over operations.

Natural Decline and Reserve Replacement Risk

Natural decline risk relates to the Company's ability to replace reserves in excess of annual production declines through development activities such as drilling, well completions, well workovers and other capital activities. The Company manages its business using a portfolio approach whereby capital is allocated across a number of areas so that significant capital is not risked on any one activity. Capital is spent only after strict economic criteria for production and reserve additions are assessed.

The Company's reserves are evaluated on an annual basis by independent third-party consultants reporting to the Company's Reserves Committee of the Board of Directors. The Company's approach is to invest in mature, long-life

properties with a high proved producing component combined with low-risk development opportunities where the reserve risk is generally lower and cash flows are more stable and predictable. The Company will engage in wildcat exploration activities only after considerable due diligence has been completed on the play, including geological, geophysical and total capital required.

Environmental Health and Safety Risk

Environment, health and safety risks relate primarily to field operations associated with oil and gas assets. To mitigate this risk, a preventative environmental, health and safety program is in place as well as operational loss insurance coverage. Arsenal employees and contractors adhere to the Company's environment, health and safety program, which is routinely reviewed and updated to ensure that the Company operates in a manner consistent with best practices in the industry. The Board of Directors is actively involved in the risk assessment and risk mitigation process.

Regulation, Tax and Royalty Risk

Regulation, tax and royalty risk relates to changing government royalty regulations, income tax laws and incentive programs impacting the Company's financial and operating results. Management, with the assistance of legal and accounting professionals, stay informed of proposed changes in laws and regulations and proactively respond to and plan for the effects of these changes.

Capital Market Risk

The Company's ability to maintain its financial strength and liquidity is dependent upon its ability to access Canadian capital markets. If Canadian debt or equity markets were to become less accessible to the Company, it may affect the ability of Arsenal to continue to replace production.

Critical Accounting Estimates

The consolidated financial statements of Arsenal filed on Sedar include the accounts of Arsenal and its 100% owned subsidiaries, Arsenal Energy USA Inc., Quadra Resources Corp. and GEOCAN Energy Inc. The 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 are in conformity with Canadian GAAP and have been prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets liabilities, revenues and expenses. Management reviews its estimates on a regular basis.

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.

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%. All other equipment is carried at the lesser of depreciated cost and fair value.

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.

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.

Financial Instruments

Cash and cash equivalents 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 and revolving demand loan 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.

Change in Accounting Policies

Accounting Changes

Financial Instruments - Disclosure and Presentation

The Company has adopted new accounting standards concerning "Financial Instruments – Disclosure and Presentation" 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.

The financial instruments standard establishes the disclosure and presentation financial instruments and non-financial derivatives. The standard addresses accounting policy disclosures involving the criteria for designating as "held-for-trading" and those financial instruments that are not required to be classified as "held-for-trading." In addition, new disclosure requirements include offsetting, and the format, location and classes of financial instruments, along with the terms and conditions, interest rate and credit risk.

Capital Disclosures

Effective January 1, 2008, the Company adopted new standards Capital Disclosures. The standard 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.

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.