

Consolidated Financial Statements of

ARSENAL ENERGY INC.

Years ended December 31, 2009 and 2008

MANAGEMENT'S REPORT

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

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

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

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

"signed"

Tony van Winkoop

President and Chief Executive Officer

"signed"

William Hews

Chairman of the Audit Committee

March 15, 2010

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Arsenal Energy Inc. as at December 31, 2009 and 2008 and the consolidated statements of operations and deficit , comprehensive income (loss) and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) "KPMG LLP"

Chartered Accountants
Calgary, Canada
March 15, 2010

ARSENAL ENERGY INC.

Consolidated Balance Sheets

As at	December 31, 2009	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,325,915	\$ 825,223
Accounts receivable	6,470,045	5,850,369
Prepaid expenses and deposits	532,808	556,804
Risk management contracts (note 16(a))	126,749	6,696,175
	8,455,517	13,928,571
Risk management contracts (note 16(a))	-	2,349,629
Reclamation deposit (note 9)	157,650	213,272
Property, plant and equipment (note 7 and 8)	108,267,249	127,232,156
	\$116,880,416	\$143,723,628
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 14,778,189	\$ 10,246,399
Bank loan (note 10)	22,290,000	42,002,004
Convertible debentures (note 12)	-	3,463,089
Future income tax (note 11)	36,757	2,202,600
	37,104,946	57,914,092
Risk management contracts (note 16(a))	123,371	-
Asset retirement obligations (note 13)	14,044,639	14,498,062
Future income taxes (note 11)	7,860,589	10,605,500
	59,133,545	83,017,654
Shareholders' Equity:		
Common shares (note 14(b))	100,955,986	93,515,925
Contributed surplus (note 15(b))	5,980,601	4,451,743
Common share conversion rights (note 12)	-	370,000
Accumulated other comprehensive loss	(507,506)	-
Deficit	(48,682,210)	(37,631,694)
	57,746,871	60,705,974
	\$ 116,880,416	\$ 143,723,628

Future operations (note 2)
 Segmented information (note 19)
 Commitments and contingencies (note 20)
 Subsequent events (notes 10 and 21)

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board:

"signed"
 William Hews
 Director

"signed"
 R. Neil MacKay
 Director

ARSENAL ENERGY INC.

Consolidated Statements of Operations and Deficit

Years ended December 31

	2009	2008
Revenue		
Oil and gas	\$ 37,904,565	\$ 54,633,318
Realized gain on risk management contract (note 16(a))	166,107	7,424,828
Unrealized gain on risk management contracts (note 16(a))	3,378	9,045,804
Royalties	(7,747,526)	(10,892,206)
	30,326,524	60,211,744
Other income	31,097	7,480
	30,357,621	60,219,224
Expenses		
Operating	13,684,848	15,606,576
Transportation	1,084,061	153,793
General and administrative	4,027,721	4,444,523
Finance charges and fees (recovery) (note 14(c))	1,590,176	(554,714)
Other expenses (note 5)	1,351,064	438,056
Interest on convertible debentures	34,323	278,400
Foreign exchange gain	(1,596,590)	(412,220)
Convertible debenture accretion	16,911	123,049
Property, plant and equipment impairment (note 7)	-	495,650
Depletion, depreciation and accretion	26,023,517	18,477,726
Stock-based compensation (note 15(a))	912,571	824,263
	47,128,602	39,875,102
Income (loss) before income taxes	(16,770,981)	20,344,122
Income taxes (note 11) :		
Current income tax	-	(258,981)
Future income tax (reduction)	(5,720,465)	6,013,926
	(5,720,465)	5,754,945
Net income (loss) for the year	(11,050,516)	14,589,177
Deficit, beginning of year	(37,631,694)	(52,220,871)
Deficit, end of year	\$ (48,682,210)	\$ (37,631,694)
Income (loss) per share, basic and diluted (note 14(e))	\$ (0.11)	\$ 0.16

Consolidated Statement of Comprehensive Income (Loss)

	2009	2008
Net income (loss) for the year	\$ (11,050,516)	\$ 14,589,177
Translation losses on foreign operations	(507,506)	-
Comprehensive income (loss)	\$ (11,558,022)	\$ 14,589,177

See accompanying notes to consolidated financial statements.

ARSENAL ENERGY INC.

Consolidated Statements of Cash Flows

Years ended December 31

	2009	2008
Cash provided by (used in):		
Operations:		
Net income (loss) for the year	\$(11,050,516)	\$ 14,589,177
Items not affecting cash:		
Unrealized gain on risk management contracts	(3,378)	(9,045,804)
Non-cash general and administrative	504,580	225,000
Property, plant and equipment impairment	-	495,650
Depletion, depreciation and accretion	26,023,517	18,477,726
Future income tax expense (reduction)	(5,720,465)	6,013,926
Convertible debenture accretion	16,911	123,049
Stock-based compensation	912,571	824,263
Unrealized foreign exchange gain	(1,188,404)	(412,220)
Settlement of risk management contracts (note 16)	9,211,912	-
Asset retirement obligations settled	(558,798)	(525,475)
	18,147,930	30,765,292
Net change in non-cash working capital (note 18)	(45,587)	(745,930)
	18,102,343	30,019,362
Financing:		
Bank loan (repayments)	(19,712,004)	18,909,565
Repayment of convertible debentures	(3,480,000)	-
Issue of shares for cash	9,000,000	4,787,059
Issue of shares on exercise of stock options	-	90,217
Repurchase of shares	-	(31,200)
Share issue expenses	(665,580)	(392,062)
Net change in non-cash working capital items (note 18)	(60,270)	(24,632)
	(14,917,854)	23,338,947
Investing:		
Additions to property, plant and equipment	(10,471,357)	(21,236,860)
Acquisition of GEOCAN (note 5)	-	(30,420,000)
Disposition of property, plant and equipment (note 7)	4,121,234	2,863,999
Acquisition of property	(479,084)	(728,012)
Net change in non-cash working capital items (note 18)	4,276,651	(4,346,263)
	(2,552,556)	(53,867,136)
Foreign exchange loss on cash held in foreign currency	(131,241)	(46,519)
Change in cash and cash equivalents during the year	500,692	(555,346)
Cash and cash equivalents, beginning of year	825,223	1,380,569
Cash and cash equivalents, end of year	\$ 1,325,915	\$ 825,223

Supplemental information (note 18)

See accompanying notes to consolidated financial statements.

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2009 and 2008

1. Basis of presentation:

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

2. Future operations:

Future operations of the Company is dependent on its ability to successfully explore, develop, and produce economically viable reserves and market petroleum products from its properties, raise capital to support its activities and meet its obligations, and receiving the continued financial support from its lender (note 10). As at December 31, 2009, the Company has debt and working capital deficiency (excluding risk management contracts and related future income taxes) totaling \$28.7 million and has incurred significant losses to date. On February 26, 2010 the Company completed the issuance of 11.3 million common shares and 3 million flow-through common shares for total gross proceeds of \$12.6 million. The proceeds were initially applied to reduce the Company's bank loan (see note 21).

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

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

3. Significant accounting policies:

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

a) Revenue recognition:

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

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%.

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2009 and 2008

3. Significant accounting policies (continued):

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, plus the carrying amount 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 to an amount equal to the estimated net present value of future cash flows from proved plus probable reserves plus the carrying amount of unproved properties. This impairment in the carrying amount would be recognized and charged to current operations as an impairment of assets.

d) Depletion and depreciation:

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 is amortized using the unit-of-production method based on current period production and estimated gross proved oil and gas reserves, before royalties, 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.

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2009 and 2008

3. Significant accounting policies (continued):

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:

Effective April 1, 2009 the Company translates foreign currency denominated transactions and the financial statements of self-sustaining foreign operations using the current rate method. Accordingly, the assets and liabilities are translated at period-end exchange rates, while revenues and expenses are translated using average rates for the period. Translation gains and losses related to the operations are included in other comprehensive income and included in accumulated other comprehensive income as a separate component of shareholders' equity.

Previously, U.S. operations were considered to be integrated and translated using the temporal method. Under the temporal method, monetary assets and liabilities were translated at the period end exchange rates, other assets and liabilities at the historical rates and revenues and expenses were translated in the period they occurred. Exchange gains and losses on translation of monetary assets and liabilities were 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.

l) Financial instruments:

Cash and cash equivalents and reclamation deposit are designated as "held-for-trading" and are measured at fair value, which approximates carrying value. Accounts receivable are designated as "loans and receivables." Accounts payable and accrued liabilities, bank loan and convertible debt are designated as "other liabilities."

The Company uses financial instruments for non-trading purposes to manage fluctuations in commodity prices. All unrealized risk management contracts that either do not qualify as hedges, or are not designated as hedges, are recorded as a risk management contract asset or a risk

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2009 and 2008

3. Significant accounting policies (continued):

management contract 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.

4. Change in accounting policies:

Translation of foreign currencies

Effective April 1, 2009, the Company determined that the functional currency of its U.S. operations had changed from the Canadian dollar to the U.S. dollar due to significant changes in facts and circumstances, being the recent financing for and cash flow generated from U.S. operations being denominated in U.S. dollars and being self-sustaining from that of the parent. Accordingly, the accounts of self-sustaining foreign operations are translated using the current rate method, whereby assets and liabilities are translated at period-end exchange rates, while revenues and expenses are translated using average rates for the period. Translation gains and losses related to the operations are included in other comprehensive income and included in accumulated other comprehensive loss as a separate component of shareholders' equity.

Previously, U.S. operations were considered to be integrated and translated using the temporal method. Under the temporal method, monetary assets and liabilities were translated at the period end exchange rates, other assets and liabilities at the historical rates and revenues and expenses were translated in the period they occurred.

Goodwill and Intangible Assets

On January 1, 2009, the Company adopted the new standard for goodwill and intangible assets. The new standard replaces the previous goodwill and intangible asset standard and revises the requirement for recognition, measurement, presentation and disclosure of intangible assets. The adoption of this standard has had no impact on the Company's Consolidated Financial Statements.

Financial Instruments

In May 2009, the Canadian Institute of Chartered Accountants amended Section 3862, "Financial Instruments – Disclosures," to include additional disclosure requirements about fair value measurement for financial instruments and liquidity risk disclosures. These amendments require a three level hierarchy that reflects the significance of the inputs used in making the fair value measurements. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly. Level 3 valuations are based on inputs that are unobservable and significant to the overall fair value measurement. These amendments are effective for the Company in 2009 and resulted in increased disclosure. See note 16.

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2009 and 2008

4. Change in accounting policies (continued):

Pending Accounting Pronouncements

Business combinations

In December 2008, the CICA issued Section 1582, Business Combinations. This section is effective January 1, 2011 and applies 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. This section replaces Section 1581, Business Combination and harmonizes the Canadian standards with IFRS.

In 2009 Section 1601 and Section 1602 were issued which replace the existing guidance under section 1600, Financial Statements. These standards provide guidance for preparing financial statements and for accounting for non-controlling interest in a subsidiary subsequent to a business combination. These standards are effective for business combinations occurring on or after January 1, 2011, with early adoption permitted.

5. Business acquisition:

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

Net asset acquired at assigned values:

Working capital deficiency	\$ (2,941,351)
Bank loan	(11,040,973)
Risk management liability	(476,641)
Property, plant and equipment	60,368,543
Asset retirement obligation	(5,154,550)
Future income taxes	(1,884,347)
Net assets acquired	\$ 38,870,681

Consideration:

Cash	\$ 30,000,000
Shares issued	8,445,681
Acquisition costs	425,000
Purchase price	\$ 38,870,681

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

The Company has recorded other expenses in the statement of operations in the amount of \$741,064 that were incurred after the purchase price had been finalized and are not reflective of current operating results.

6. Related party transactions:

An officer of the Company is a partner in a law firm that provides legal services to the Company. In 2009, the Company incurred a total of \$158,887 (2008 - \$ 307,485) for legal fees and disbursements.

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2009 and 2008

As at December 31, 2009, accounts payable include \$42,232 (2008 - \$23,166) relating to these payments.

6. Related party transactions (continued):

A Director of the Company is a partner in a law firm that provides legal services to the Company. In 2009, the Company recorded a total of \$3,484 (2008 - \$nil) for legal fees and disbursements. As at December 31, 2009 accounts payable include \$nil (2008 - \$nil) relating to these payments.

7. Property, plant and equipment:

	2009	2008
Petroleum and natural gas properties	\$ 159,328,416	\$ 154,923,250
Production equipment	30,002,163	28,829,593
	189,330,579	183,752,843
Office furniture, equipment, and other	443,343	531,743
	189,773,922	184,284,586
Accumulated depletion and depreciation	(81,506,673)	(57,052,430)
	\$ 108,267,249	\$ 127,232,156

In Canada and the United States, all costs of unproved properties have been capitalized, and depleted during 2009 and for 2008. Future development costs totaling \$2,552,700 (December 31, 2008 - \$4,400,000) in Canada and \$27,546,395 (December 31, 2008 - \$5,200,000) in the United States were included in the depletion calculation.

During 2008, the Company recorded a full impairment to its Egyptian property of \$495,650. These costs related to land acquisition costs, evaluation costs, and drilling activities. As at December 31, 2008, the Company had written off its interest in its Egyptian concession.

For the year ended December 31, 2009, Arsenal capitalized direct general and administrative expenses of \$351,600 (2008 - \$472,321) and \$211,803 (2008 - \$140,342) of stock based compensation and \$75,193 (2008 - \$58,727) of future tax related thereto.

During 2009, the Company disposed of certain non-core properties for proceeds of \$4,121,234 (2008 - \$2,863,999). In addition, the Company disposed of asset retirement obligations relating to the properties sold of approximately \$2,541,950 (2008 - \$nil).

8. Ceiling test:

On December 31, 2009 Arsenal completed a ceiling test on its Canadian and U.S. cost centers to assess if the property, plant and equipment costs would be recoverable by comparing the undiscounted cash flow from proved reserves of the cost centre to the carrying amount. The prices used in the ceiling test evaluation of Arsenal's natural gas, crude oil, and natural gas liquids reserves, as determined by independent engineers at December 31, 2009 were as follows:

Year	WTI Cushing Oklahoma (\$US/bbl)	Edmonton Par Price 40 Deg. API (\$CDN/bbl)	Natural Gas AECO-C Price (\$CDN/mcf)	NGLs Edmonton Butanes Plant Gat (\$CDN/bbl)	NGLs Edmonton Pentanes Plant Gat (\$CDN/bbl)	Exchange Rate (\$US/\$CDN)
2010	75.00	77.55	5.80	62.05	81.45	0.95
2011	81.60	84.45	6.70	67.55	88.65	0.95
2012	85.85	88.90	7.05	71.10	93.35	0.95

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2009 and 2008

2013	90.20	93.45	7.45	74.75	98.15	0.95
2014	97.40	101.05	7.55	80.85	106.10	0.95
Thereafter			Escalation rate of 2%			

8. Ceiling test (continued):

Pursuant to the ceiling test calculations, the Company concluded that no impairment exists as at December 31, 2009.

9. Reclamation deposit:

At December 31, 2009 the Company had \$157,650 (2008 - \$213,272) on deposit with the United States Federal and State governments for future site reclamation activities. These funds will remain on deposit until the Company abandons and reclaims well sites in the United States.

10. Revolving demand loan:

At December 31, 2009, the Company had a \$35,080,000 credit facility consisting of a demand revolving operating loan facility in the amount of \$31,000,000 (\$18,210,000 outstanding at December 31, 2009) and a non-revolving reducing term loan facility of \$4,080,000 (\$4,080,000 outstanding December 31, 2009). The facility can be utilized in either Canadian or U.S. dollars. The operating loan facility is scheduled for review on May 31, 2010 or at the discretion of the lender. The amount of the facility is subject to a borrowing base test performed on a periodic basis, primarily based on reserves, using commodity prices estimated by the lender, as well as other factors. During 2009, the Company incurred interest on its credit facilities in the amount of \$1,116,505 (2008 - \$795,667).

Reductions in the non-revolving reducing term loan facility are set at \$820,000 per month resulting in the extinguishment of the facility by May 31, 2010. Debt under the facility, that includes bank loan and working capital deficiency but excludes the risk management contracts, future income taxes and asset retirement obligations, amounted to \$28,739,421 at December 31, 2009 (2008 - \$48,479,097). Included in debt under the facility is a U.S. \$10,000,000 (CAD - \$10,510,000) Libor based loan as at December 31, 2009.

Interest on the Company's demand revolving operating loan facility is at rates ranging from Canadian or U.S. prime plus 1.25% to 2.25% on prime based loans, from the base rate plus 2.75% to 3.75% on guaranteed notes and from the Libor base rate plus 2.75% to 3.75% on Libor based loans. Interest on the Company's non-revolving reducing term loan facility is at Canadian or U.S. prime plus 3.00% on prime based loans and from the base rate plus 4.50% on guaranteed notes and Libor based loans. Borrowings of guaranteed notes and Libor loans are limited under the non-revolving reducing term loan facility to 60% of the outstanding balance.

The interest rate is set based on the net debt to trailing funds flow ratio, as defined in the agreement, (funds flow for the last quarter annualized).

Pursuant to the loan 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.

The Company is in compliance with its bank covenants at December 31, 2009.

The credit 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.

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)

Years ended December 31, 2009 and 2008

On January 29, 2010, the Corporation repaid the non-revolving reducing term loan; as a result this facility is no longer available to the Corporation.

11. Income taxes:

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

	2009	2008
Income (loss) before income taxes	\$ (16,770,981)	\$ 20,344,122
Combined federal and provincial tax rate	29.17%	29.83%
Expected tax provision (recovery)	(4,892,095)	6,068,892
Increase (decrease) in taxes resulting from:		
Stock-based compensation	266,216	245,877
Change in tax rates	337,729	(354,501)
Tax impact of foreign jurisdictions	64,187	(2,049,732)
Income tax adjustments	(1,840,330)	1,047,135
Foreign exchange	226,016	-
Change in valuation allowance	28,125	868,921
Other	89,687	(71,647)
	\$ (5,720,465)	\$ 5,754,945

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

	2009	2008
Future tax liability (asset):		
Property, plant and equipment	\$ 16,834,000	\$ 18,723,913
Share issue costs	(503,550)	(512,957)
Asset retirement obligations	(3,917,743)	(3,898,228)
Unrealized foreign exchange gain	694,404	168,818
Unrealized gain on commodity contracts	(55,460)	2,870,832
Non-capital losses	(5,146,927)	(4,544,278)
Net capital losses	(897,046)	(868,921)
Valuation allowance	897,046	868,921
Other	(7,378)	-
Net future income tax liability	\$ 7,897,346	\$ 12,808,100

The Company has non-capital losses of approximately \$18.2 million as at December 31, 2009 that expire between 2026 and 2029.

12. Convertible debentures:

Arsenal completed a corporate acquisition on March 14, 2006, and acquired unsecured convertible debentures totaling \$3,480,000. The convertible debentures were a debt security with an embedded conversion option and were segregated into a debt and equity component based on the respective fair value of each at the date of acquisition. The equity component of \$370,000 represented the holder's conversion right and was included in Shareholders' Equity. The remaining balance was classified as debt and was being accreted over the remaining period to maturity to the face value of

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the debenture. The interest accrued on the debentures at 8%, payable semi-annually on June 30th and December 31st of each year. The debentures matured and were repaid on February 15, 2009 and the holders conversion rights were reclassified to contributed surplus.

13. Asset retirement obligations:

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

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

Changes to the asset retirement obligations were as follows:

	2009	2008
Asset retirement obligations, beginning of year	\$ 14,498,062	\$ 3,697,721
Liabilities settled	(558,798)	(525,475)
Liabilities acquired	208,769	5,214,917
Liabilities disposed	(2,541,950)	-
Liabilities incurred	134,476	521,277
Change in estimate	1,619,119	5,262,397
Foreign currency translation	(343,818)	-
Accretion expense	1,028,779	327,225
Asset retirement obligations, end of year	\$ 14,044,639	\$ 14,498,062

For the year ended December 31, 2009, the Company has changed its estimated costs to reclaim and abandon the wells, gathering systems and facilities and the estimated timing of the costs to be incurred in future periods resulting in an increase of \$1,619,119 (2008 - \$5,262,397).

The total undiscounted amount of estimated cash flows required to settle the obligation is \$35.5 million (2008 - \$34.4 million), which has been discounted using a credit-adjusted risk free rate of 8.0% (2008 - 8.0%) and an inflation factor of 1.5% (2008 - 1.5%). The majority of these obligations will be incurred between 2017 and 2022; however approximately \$9.0 million in obligations are not anticipated to be incurred until after 2030.

14. Shareholder's equity:

a) Authorized:

Unlimited number of common shares

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

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14. Shareholder's equity (continued):

b) Issued:

	December 31, 2009		December 31, 2008	
	Number	Amount	Number	Amount
Common shares:				
Balance, beginning of year	101,249,646	\$ 93,515,925	83,698,042	\$ 81,901,603
Issued to acquire GEOCAN	-	-	10,623,498	8,445,681
Issued on exercise of options	-	-	283,251	90,217
Issued for cash pursuant to private placement	8,000,000	4,000,000	1,249,300	787,059
Issued for cash pursuant to private placement of flow-through shares	11,250,000	5,000,000	5,555,555	4,000,000
Tax effect of flow-through shares	-	(1,040,000)	-	(1,356,625)
Share issue costs	-	(665,580)	-	(392,062)
Tax effect of share issue costs	-	180,125	-	127,425
Unclaimed shares returned to treasury	(37,756)	(34,484)	-	-
Allocated from contributed surplus	-	-	-	60,490
Normal course issuer bid	-	-	(160,000)	(147,863)
Balance, end of year	120,461,890	\$ 100,955,986	101,249,646	\$ 93,515,925

Common Shares

On December 17, 2009, the Company issued 8,000,000 common shares at \$0.50 per share for gross proceeds of \$4,000,000 for which directors and officers of the Company subscribed for 1,680,700 shares for gross proceeds of \$840,350.

In July 2009, the Company cancelled 37,756 common shares by returning them to treasury pursuant to a sunset clause in a prior corporate acquisition. Shareholders of the acquired company failed to tender their shares by the required deadline. The deemed cost of the shares was \$34,484 (\$0.91 per share).

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

In March and April 2008, the Company issued 1,249,300 common shares at \$0.63 per share for gross proceeds of \$787,059, of which an officer of the Company subscribed for 289,500 common shares for gross proceeds of \$182,385.

c) Flow-through shares:

On December 17, 2009, the Company issued 2,500,000 flow-through common shares at \$0.60 per share for gross proceeds of \$1,500,000. The terms of the share issue requires the Company

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to incur Canadian Exploration Expenses in the amount of \$1,500,000 by December 31, 2010. As at December 31, 2009, no exploration costs had been incurred on this issuance.

In September 2009, the Company issued 8,750,000 flow-through common shares at \$0.40 per share for gross proceeds of \$3,500,000, for which directors and officers of the Company subscribed for 612,500 flow-through common shares for gross proceeds of \$245,000. The terms

14. Shareholder's equity (continued):

of the share issue requires the Company incur Canadian Exploration Expenses in the amount of \$3,500,000 by December 31, 2010. As at December 31, 2009, approximately \$1.2 million has been expended on exploration leaving approximately \$2.3 million to be incurred by December 31, 2010.

In March and April 2008, the Company issued 5,555,555 flow-through common shares at \$0.72 per share for gross proceeds of \$4,000,000, for which officers of the Company subscribed for 34,000 flow-through common shares for gross proceeds of \$24,480. As at December 31, 2009, all exploration costs had been incurred.

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

In 2008, the Company and CRA completed their review and discussions on the audit of the Qualifying Expenditures and the related interest costs which resulted in a reduction of finance charges of \$693,764. Finance charges and fees for 2008 represents interest paid on the Company's credit facilities of \$795,667, other interest costs of \$29,908, net of the reduction of the flow-through provision of \$1,519,339.

d) Escrowed shares:

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

e) Per share amounts:

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

	2009	2008
Basic and diluted:		
Income (loss) per share basic and diluted	\$ (0.11)	\$ 0.16
Shares outstanding:		
Basic	104,546,073	88,937,656
Diluted	104,546,073	89,199,940

In calculating the per share amounts for the year ended December 31, 2009, 9,322,000 (2008 – 6,155,038) options were excluded from the dilution calculation, as they were anti-dilutive.

f) Normal course issuer bid:

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In October 2008, the Company received approval for a normal course issuer bid (NCIB) program for the repurchase and cancellation of its common shares. The program was initiated in October 2008 to repurchase up to 4,539,307 of its common shares during the period from October 16, 2008 to October 15, 2009. Any purchases will be made on the open market through the TSX at the market price of such shares at the time of acquisition. During 2009, the Company did not repurchase any shares under the NCIB. During 2008, the Company repurchased and cancelled

14. Shareholder's equity (continued):

160,000 shares at a cost of \$31,200. The stated value of these shares exceeded their cost by \$116,663 (see note 15(b)). This excess has been recorded to contributed surplus.

15. Stock options:

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

The following table summarizes the status of the Company's stock option plan as at December 31, 2009 and December 31, 2008 and the changes during those years:

	December 31, 2009		December 31, 2008	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Balance, beginning of year	7,361,000	\$ 0.70	3,758,919	\$ 0.88
Granted	3,133,000	0.31	4,296,000	0.55
Exercised	-	-	(283,251)	0.32
Expirations	(150,000)	0.59	-	-
Forfeited	(1,022,000)	0.94	(410,668)	1.01
Balance, end of year	9,322,000	\$ 0.55	7,361,000	\$ 0.70
Exercisable, end of year	4,991,999	\$ 0.73	3,962,334	\$ 0.86

The following table summarizes information about the stock options outstanding and exercisable at December 31, 2009:

	Options outstanding			Options exercisable		
Range of exercise prices	Number of options	Weighted average exercise price	Weighted average remaining life (years)	Number of options	Weighted average exercise price	
\$0.20 to \$0.35	1,676,000	\$ 0.21	4.00	-	\$ -	-
\$0.36 to \$0.50	3,816,000	0.40	3.97	1,253,666	0.39	
\$0.51 to \$0.70	1,500,000	0.60	3.15	1,500,000	0.60	
\$0.71 to \$1.00	1,150,000	0.79	3.33	1,058,333	0.80	

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\$1.01 to \$1.50	1,180,000	1.18	0.92	1,180,000	1.18
Total	9,322,000	\$ 0.55	3.38	4,991,999	\$ 0.73

15. Stock options (continued):

a) Stock-based compensation expense:

Options granted to employees and non-employees are accounted for using the fair value method. The fair value of stock options granted during 2009 was \$828,856 (\$0.26 per option) (2008 - \$2,057,684 (\$0.48 per option)) as estimated at the date of grant using the Black-Scholes option-pricing model with weighted average assumptions for grants as follows:

	2009	2008
Risk free rate	1.46 – 2.88%	2.64 – 3.25%
Expected life	5 years	5 years
Expected volatility	89 – 152%	125 – 137%
Expected dividend	nil	nil
Expected forfeitures	nil	nil

b) Contributed surplus:

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

	2009	2008
Balance, beginning of year:	\$ 4,451,743	\$ 3,430,965
Stock-based compensation expensed	912,571	824,263
Stock-based compensation capitalized	211,803	140,342
Reclassification of options exercised	-	(60,490)
Reclassification of equity component of debenture (note 12)	370,000	-
Unclaimed shares returned to treasury	34,484	-
Premium on NCIB (note 14(f))	-	116,663
Balance, end of year	\$ 5,980,601	\$ 4,451,743

16. Risk management and financial instruments:

a) Commodity price risk management:

Commodity price risk is the risk that future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian and United States dollar as well as global economic events that dictate the levels of supply and demand. The Company has attempted to mitigate a portion of the commodity price risk through the use of commodity price contracts. The Company's policy is to enter into commodity price contracts when considered appropriate.

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As at December 31, 2009, the Company has four crude oil swaps and two natural gas swaps in-place fixing the price of future production. All risk management contracts are denominated in Canadian dollars. For the year ended December 31, 2009, the Company recorded a realized commodity contract gain of \$166,107 (2008 - \$7,424,828) and an unrealized commodity contract gain of \$3,378 (2008 - \$9,045,804). The Company assigned two risk management contracts to its U.S. subsidiary's production. The remaining four contracts relate to Canadian production. As at December 31, 2009 the Company has recorded a current future income tax liability in the amount of \$36,757 as a result of the current unrealized gain of \$126,749.

16. Risk management and financial instruments (continued):

The following table details the year end mark-to-market risk management contract presentation in the financial statements at the dates indicated:

	2009	2008
Total fair value consists of the following:		
Fair value - current	\$ 126,749	\$ 6,696,177
Fair value - long-term	(123,371)	2,349,622
Total fair value, end of period	\$ 3,378	\$ 9,045,800

The following table reconciles the changes in the fair value of risk management contracts outstanding at the dates indicated:

	2009	2008
Fair value, beginning of period	\$ 9,045,800	\$ -
Changes in fair value	169,480	16,470,630
Settlement paid	(9,211,912)	(7,424,828)
Fair value, end of period	\$ 3,378	\$ 9,045,800

The Company had the following risk management contract outstanding as at December 31, 2009.

Commodity Sold	Volume Sold	Remaining Term	Pricing	Fair Value
Natural Gas	1,000 GJ per day	Jan 1, 2010 - Dec 31, 2010	\$6.78 per GJ	\$ 484,091
Natural Gas	1,000 GJ per day	Jan 1, 2010 - Mar 31, 2010	\$5.50 per GJ	11,525
Oil	100 bbl per day	Jan 1, 2010 - Apr 30, 2010	\$72.60 per bbl	(145,847)
Oil	100 bbl per day	May 1, 2010 - Apr 30, 2011	\$79.50 per bbl	(324,200)
Oil	200 bbl per day	Jan 1, 2010 - Dec 31, 2010	\$85.05 per bbl	(124,470)
Oil	300 bbl per day	Jan 1, 2010 - Dec 31, 2010	\$87.70 per bbl	102,279
				\$ 3,378

Commodity price sensitivity:

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Commodity	2009	2008
Natural gas production sold under fixed commodity contract	455,00	365,00
Price	\$ 0.1	\$ 0.1
Sensitivity - net	\$ 45,50	\$ 36,50

Commodity	2009	2008
Oil production sold under fixed commodity contract	231,00	188,00
Price	\$ 1.0	\$ 1.0
Sensitivity - net	\$ 231,00	\$ 188,00

16. Risk management and financial instruments (continued):

b) Fair value of financial instruments:

The Company's exposure under its financial instruments is limited to financial assets and liabilities, all of which are included in these financial statements. Financial instruments include cash and cash equivalents, reclamation bonds, accounts receivable, accounts payable and accrued liabilities, risk management contracts and bank debt. The fair values of financial assets and liabilities that are included in the balance sheet approximate their carrying amounts. Certain of these financial instruments including risk management contracts are measured in the financial statements at fair value. These financial instruments require disclosure about how fair value was determined based on significant levels of inputs described in the following hierarchy:

- Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and value to provide pricing information on an ongoing basis.
- Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices in Level 2 are either directly or indirectly observable as of the reporting date. Level 2 valuations are based on inputs including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace.
- Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data

The fair value of risk management contracts as presented on the balance sheet is determined by discounting the difference between the contracted price and published forward price curves as at the balance sheet date, using the remaining contracted oil and natural gas volumes and are considered Level 2.

c) Credit risk:

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

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

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As at December 31, 2009 the Company's receivables consisted of \$2,636,881 (2008 - \$1,055,623) from joint interest partners the majority of which has either been collected or is expected to be collected within the next 60 days, \$2,922,179 (2008 - \$3,224,180) of receivables from petroleum and natural gas marketers, which have been collected and \$910,985 (2008 - \$1,570,566) of other receivables. At December 31, 2009, Arsenal had approximately \$948,160 (2008 - \$500,000) of receivables that are considered past due and collection efforts, including the taking of production and consideration of legal action have commenced.

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint interest receivables are typically collected within one to three months of the joint interest bill being issued to the partner. The Company attempts to mitigate the risk from joint interest receivables by obtaining partner approval of significant capital expenditures and payment of cash advances prior to expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances are dependent on industry factors such as

16. Risk management and financial instruments (continued):

commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition further risk exists with joint interest partners as disagreements occasionally arise that increase the potential for non-collection. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint interest partners; however the Company does have the ability to request deposits and to withhold production from joint interest partners in the event of non-payment.

The carrying amount of cash and cash equivalents and accounts receivable represents the maximum credit exposure. The Company did not have an allowance for doubtful accounts as at December 31, 2009 (December 31, 2008 - nil).

As at December 31, 2009 the Company considers its receivables to be aged as follows:

Aging	December 31, 2009
Not past due	\$ 5,521,885
Past due by more than 90 days	948,160
Total	\$ 6,470,045

d) Foreign currency exchange risk:

The Company is exposed to foreign currency fluctuations as crude oil and natural gas prices received are referenced to United States dollar denominated prices, and revenues earned and costs incurred in the United States are denominated in United States dollars. The Company has mitigated a portion of this exchange risk by entering into fixed Canadian dollar crude oil price swaps as outlined in the commodity price risk section above. At December 31, 2009, the Company had outstanding U.S. \$10,000,000 (CAD - \$10,510,000) of Libor based loans. A \$0.01 increase or decrease in the Canadian / United States foreign exchange rate would increase or decrease, as the case may be, net loss before future income taxes by approximately \$100,000.

e) Interest rate risk:

The Company is exposed to interest rate risk to the extent that the revolving demand loan is at a floating rate of interest. Based on \$34.4 million average bank debt outstanding over the year ending December 31, 2009, a 100 basis point (1%) change in the interest rate would increase or decrease interest expense for the year by \$344,305.

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All debt is denominated in Canadian dollars, except for U.S. \$10,000,000 (CAD - \$10,510,000) of Libor based loans.

f) Liquidity risk:

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as much as possible, that it will always have sufficient liquidity to meet its liabilities when due, under normal and stressed conditions. Management closely monitors cash flow requirements to ensure that it has sufficient cash on demand or borrowing capacity to meet operational and financial obligation. At December 31, 2009, the Company had a \$35.08 million credit facility (see note 10).

17. 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 were redeemed in February 2009 funded by an increase in bank debt. The Company can access or increase its capital base through the issuance of shares and through bank borrowings that are based on reserves. The Company can safeguard its capital base by stabilizing its funds from operations, by fixing commodity prices on a portion of the Company's production and by closely monitoring expenses and by closely monitoring and scrutinizing the results of its capital expenditure program and adjusting expenditures as required based on economic conditions and drilling results.

The Company monitors its capital base based primarily on its net debt to annualized funds flow ratio and its debt to equity ratios. Debt includes bank debt, plus or minus working capital. Annualized funds flow is calculated as cash flow from operations before changes in non-cash working capital and asset retirement expenditures from the Company's most recent quarter multiplied by four adjusted, if required, by increasing or decreasing commodity price expectations and future production profiles. The Company's goal is to target this ratio at 1 : 1 but it can and will fluctuate based on the timing of property transactions, commodity prices and on the mix of exploratory and development drilling. During periods of extreme commodity price declines, high drilling activity or after large property or corporate acquisitions, it is expected that the ratio would increase and during periods of high commodity prices and low activity levels, 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 reviews changes thereto.

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At December 31, 2009, the Company's debt to annualized funds flow ratio was 2.07 : 1 and its debt to equity ratio was 0.51 : 1. An equity issue of \$5.5 million in late Q4 2009 helped with debt reduction thereby improving the debt to annualized funds flow ratio. The debt to forward funds from operations ratio at December 31, 2009 is higher than the corporate goal of 1 : 1 as established in the management strategy goals and guidelines due primarily to reduced commodity prices and therefore lower funds from operations and due to the acquisition of GEOCAN in mid 2008 using primarily debt followed by a significant decline in commodity prices and thus cash flow from operations.

The Company cannot permit the working capital ratio (as defined in the bank loan agreement to include the unutilized portion of the facility) to fall below 1 : 1. At December 31, 2009, the Company has complied with this external financial covenant.

The Company's share capital is not subject to external restrictions, however the credit facilities are petroleum and natural gas reserves based. The Company has not paid or declared any dividends since the date of incorporation and does not do so in the foreseeable future.

17. Capital management (continued):

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

	December 31, 2009
Bank loan	\$ 22,290,000
Working capital (excluding risk management contracts and future income taxes)	6,449,421
Total debt	\$ 28,739,421
Annualized funds flow	\$ 13,887,640
Net debt to annualized funds flow ratio	2.07

18. Supplemental cash flow information:

	2009	2008
Change in non-cash working capital items:		
Accounts receivable	\$ 1,091,153	\$ 872,503
Prepaid expenses and deposits	(23,996)	(176,426)
Accounts payable and accrued liabilities	(5,237,951)	(5,812,902)
	4,170,794	(5,116,825)
Amounts relating to operating activities	(45,587)	(745,930)
Amounts relating to financing activities	(60,270)	(24,632)
Amounts relating to investing activities	4,276,651	(4,346,263)
	4,170,794	(5,116,825)
Interest and taxes paid:		
Taxes paid	\$ -	\$ 107,243
Interest paid	\$ 1,327,184	\$ 825,575

19. Segmented information:

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

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2009 (\$Cdn.)	Canada	U.S.	Egypt	Total
Oil and gas revenue	27,396,386	10,508,179	-	37,904,565
Income (loss) before income taxes	(17,363,662)	592,681	-	(16,770,981)
Operating income ¹	11,242,738	4,145,392	-	15,388,130
Property, plant and equipment (note 5)	97,686,924	10,580,325	-	108,267,249
Acquisition of property	479,084	-	-	479,084
Property dispositions	(4,121,234)	-	-	(4,121,234)
Capital expenditures	4,558,422	5,912,935	-	10,471,357

2008 (\$Cdn.)	Canada	U.S.	Egypt	Total
Oil and gas revenue	42,496,396	12,136,922	-	54,633,318
Income (loss) before income taxes	17,225,337	3,854,383	(735,598)	20,344,122
Operating income ¹	23,306,893	4,673,850	-	27,980,743
Property, plant and equipment (note 5)	120,127,509	7,104,647	-	127,232,156
Acquisition of property	728,012	-	-	728,012
Property dispositions	(2,863,999)	-	-	(2,863,999)
Capital expenditures	19,140,449	2,196,411	-	21,236,860

¹ Defined as oil and gas revenues less royalties, operating costs and transportation.

20. Commitments and contingencies:

a) Flow-through shares:

In connection with the issuance of flow-through common shares in 2009, the Company incurred a commitment to incur \$5,000,000 of eligible expenditures by December 31, 2010. As at December 31, 2009, the Company had approximately \$3,800,000 remaining on its commitment.

b) Office premises and equipment leases:

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

Office premises and equipment leases	
2010	\$ 527,906
2011	494,752
2012	288,605
2013	-
Total commitment	\$ 1,311,263

c) Outstanding lawsuits:

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

21. Subsequent event:

On February 26, 2010, the Company issued 11,283,000 common shares at \$0.85 per share and 3,000,000 flow-through common shares at \$1.00 per share for total gross proceeds of \$12,590,550.

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