

Unaudited Interim Consolidated Financial Statements of

**ARSENAL ENERGY INC.**

For the Three and Nine Months ended September 30, 2009 and 2008

# ARSENAL ENERGY INC.

Interim Consolidated Balance Sheets  
(unaudited)

As at	September 30, 2009	December 31, 2008
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 1,003,235	\$ 825,223
Accounts receivable	5,723,232	5,850,369
Prepaid expenses and deposits	618,371	556,804
Risk management contracts (note 9)	766,020	6,696,175
	8,110,858	13,928,571
Risk management contracts (note 9)	68,287	2,349,629
Reclamation bonds	187,480	213,272
Property, plant and equipment (note 3)	109,877,758	127,232,156
	\$ 118,244,383	\$ 143,723,628
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 11,308,386	\$ 10,246,399
Bank loan (note 4)	29,322,000	42,002,004
Convertible debentures (note 7)	-	3,463,089
Future income tax	222,145	2,202,600
	40,852,531	57,914,092
Asset retirement obligations (note 6)	12,315,405	14,498,062
Future income taxes	10,124,069	10,605,500
	63,292,005	83,017,654
Shareholders' Equity:		
Common shares (note 8)	95,760,026	93,515,925
Contributed surplus (note 8(g))	5,770,432	4,451,743
Common share conversion rights (note 7)	-	370,000
Accumulated other comprehensive loss (note 8(i))	(741,254)	-
Deficit	(45,836,826)	(37,631,694)
	54,952,378	60,705,974
	\$ 118,244,383	\$ 143,723,628

Future operations (note 1)  
Commitments and contingencies (note 13)

See accompanying notes to interim consolidated financial statements.

# ARSENAL ENERGY INC.

Interim Consolidated Statements of Operations and Deficit  
(unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
<b>Revenue</b>				
Oil and gas	\$ 9,252,597	\$ 15,766,815	\$ 26,860,608	\$ 43,754,610
Gain on risk management contracts (note 9)	1,402,041	9,283,279	978,624	1,599,452
Royalties	(1,709,199)	(3,506,163)	(5,298,824)	(8,710,618)
	8,945,439	21,543,931	22,540,408	36,643,444
Other income	27,755	1,560	30,952	3,857
	8,973,194	21,545,491	22,571,360	36,647,301
<b>Expenses</b>				
Operating	3,212,794	2,989,728	10,251,721	10,306,922
Transportation	199,899	-	633,407	-
General and administrative	942,309	1,425,946	2,987,443	3,152,682
Finance charges and fees	409,864	80,216	1,174,677	341,779
Other expenses	10,000	-	600,000	438,056
Interest on convertible debentures	-	70,172	34,323	208,611
Foreign exchange (gain) loss	(605,132)	(229,201)	(1,709,560)	162,046
Convertible debenture accretion	-	32,574	16,911	89,489
Depletion, depreciation and accretion	5,909,734	4,052,324	19,234,834	11,447,483
Property, plant and equipment impairment (note 3)	-	-	-	495,650
Stock-based compensation (note 8(g))	211,488	235,757	750,047	537,733
	10,290,956	8,657,516	33,973,803	27,180,451
Income (loss) before income taxes	(1,317,762)	12,887,975	(11,402,443)	9,466,850
Income taxes:				
Current income taxes (recovery)	277,621	(614,509)	277,621	-
Future income tax (reduction)	302,378	3,474,291	(3,474,932)	1,852,536
	579,999	2,859,782	(3,197,311)	1,852,536
Net income (loss) for the period	(1,897,761)	10,028,193	(8,205,132)	7,614,314
Deficit, beginning of period	(43,939,065)	(54,634,750)	(37,631,694)	(52,220,871)
Deficit, end of period	\$ (45,836,826)	\$ (44,606,557)	\$ (45,836,826)	\$ (44,606,557)
Income (loss) per share, basic and diluted (note 8(d))	\$ (0.02)	\$ 0.11	\$ (0.08)	\$ 0.09

Interim Consolidated Statement of Comprehensive Loss  
(unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Net income (loss) for the period	\$ (1,897,761)	\$ 10,028,193	\$ (8,205,132)	\$ 7,614,314
Translation losses on foreign operations (note 8(i))	(392,306)	-	(741,254)	-
Comprehensive loss	\$ (2,290,067)	\$ 10,028,193	\$ (8,946,386)	\$ 7,614,314

See accompanying notes to interim consolidated financial statements.

# ARSENAL ENERGY INC.

Interim Consolidated Statements of Cash Flows  
(unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
<b>Cash provided by (used in):</b>				
<b>Operations:</b>				
Net income (loss) for the period	\$ (1,897,761)	\$ 10,028,193	\$ (8,205,132)	\$ 7,614,314
Items not affecting cash:				
Unrealized (gain) loss on risk management contracts	(1,402,041)	(9,500,783)	(978,624)	(2,449,945)
Non-cash general and administrative	-	-	-	225,000
Depletion, depreciation and accretion	5,909,734	4,052,324	19,234,834	11,447,483
Property, plant and equipment impairment	-	-	-	495,650
Future income tax expense (reduction)	302,378	3,474,291	(3,474,932)	1,852,536
Convertible debenture accretion	-	32,574	16,911	89,489
Stock-based compensation	211,488	235,757	750,047	537,733
Unrealized foreign exchange (gain) loss	(345,096)	(229,201)	(1,298,407)	162,046
Settlement of risk management contracts (note 9)	109,124	-	9,190,121	-
Asset retirement obligations settled	30,413	1,173	(324,051)	(39,756)
	2,918,239	8,094,328	14,910,767	19,934,550
Net change in non-cash working capital (note 11)	196,560	1,039,636	(821,348)	(1,342,842)
	3,114,799	9,133,964	14,089,419	18,591,708
<b>Financing:</b>				
Bank loan (repayments)	(5,308,000)	1,055,826	(12,680,004)	(3,321,459)
Repayment of convertible debentures	-	-	(3,480,000)	-
Issue of shares for cash	3,500,000	-	3,500,000	4,787,059
Issue of shares on exercise of stock options	-	25,884	-	90,217
Share issue expenses	(247,890)	(21,158)	(247,890)	(392,062)
Net change in non-cash working capital items (note 11)	61,652	(4,304)	(50,952)	(28,936)
	(1,994,238)	1,056,248	(12,958,846)	1,134,819
<b>Investing:</b>				
Additions to property, plant and equipment	(3,264,967)	(7,432,914)	(6,979,873)	(17,110,739)
Purchase of property, plant and equipment	-	-	-	(974,733)
Disposition of property, plant and equipment	265,860	-	3,431,984	1,235,792
Net change in non-cash working capital items (note 11)	1,905,397	(2,757,298)	2,706,018	(2,876,847)
	(1,093,710)	(10,190,212)	(841,871)	(19,726,527)
Foreign exchange loss on cash held in foreign currency	(58,452)	-	(110,690)	-
Change in cash and cash equivalents during the period	(31,601)	-	178,012	-
Cash and cash equivalents, beginning of period	1,034,836	-	825,223	-
Cash and cash equivalents, end of period	\$ 1,003,235	\$ -	\$ 1,003,235	\$ -

Supplemental information (note 11)

See accompanying notes to interim consolidated financial statements

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements  
(unaudited)

Three and nine months ended September 30, 2009

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## 1. Basis of presentation:

### a) Future operations

These interim unaudited consolidated financial statements of Arsenal Energy Inc. ("Arsenal" or the "Company") have been prepared by management in accordance with accounting principles generally accepted in Canada, the same accounting principles and methods as used in the financial statements for the year ended December 31, 2008 except as described below. The interim consolidated financial statement note disclosures do not include all disclosures applicable for annual financial statements. Accordingly, the interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto contained in the Company's annual report for the year ended December 31, 2008. These interim consolidated financial statements include the accounts of Arsenal and its wholly owned subsidiaries.

The 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 4). As at September 30, 2009, the Company has debt and working capital deficiency (excluding risk management contracts and related future income taxes totaling \$33.3 million and has incurred significant losses to date.

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.

### b) 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 Company (parent). Accordingly, the accounts of self-sustaining foreign operations are translated using the current rate method commencing April 1, 2009, 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 income as a separate component of shareholders' equity.

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
(unaudited)

Three and nine months ended September 30, 2009

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## 1. Basis of presentation (continued):

### b) Accounting policies (continued):

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. This change was applied prospectively beginning April 1, 2009.

#### *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 Interim 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 on December 31, 2009.

#### *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 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.

On July 23, 2009 the IASB adopted certain amendments and exemptions to IFRS 1 for 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 (related to the full cost method of accounting for oil and gas activities) to IFRS. The amendment permits the Company to apply IFRS prospectively to its full cost pool, rather than the retrospective assessment of capitalized exploration and development expenses, with the provision ~~e~~ that an impairment test, under IFRS standards, be conducted at the transition date.

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
(unaudited)

Three and nine months ended September 30, 2009

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## 1. Basis of presentation (continued):

### b) Accounting policies (continued):

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 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.

## 2. 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 debt	(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.

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
(unaudited)

Three and nine months ended September 30, 2009

### 3. Property, plant and equipment:

	September 30, 2009	December 31, 2008
Petroleum and natural gas properties	\$ 155,775,730	\$ 154,923,250
Production equipment	28,722,762	28,829,593
Office furniture, equipment, and other	443,482	531,743
	184,941,974	184,284,586
Accumulated depletion and depreciation	(75,064,216)	(57,052,430)
	\$ 109,877,758	\$ 127,232,156

In Canada and the United States, all costs of unproved properties have been capitalized, and depleted during the first nine months of 2009 and for 2008. Future development costs totaling \$3,792,500 (December 31, 2008 - \$4,400,000) in Canada and \$3,640,400 (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 period ended September 30, 2009, Arsenal capitalized direct general and administrative expenses of \$263,700 (2008 - \$200,000) and \$164,158 (2008 - \$90,863) of stock based compensation and \$57,827 (2008 - \$39,465) of future tax related thereto.

During 2009, the Company disposed of certain non-core properties for proceeds of approximately \$3.4 million. In addition, the Company disposed of asset retirement obligations relating to the properties sold of approximately \$2.3 million.

### 4. Bank loan:

At September 30, 2009, the Company had a \$37.54 million credit facility consisting of a demand revolving operating loan facility in the amount of \$31.0 million (\$26.7 million outstanding at September 30, 2009) and a non-revolving reducing term loan facility of \$6.54 million (\$2.6 million outstanding at September 30, 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. Reductions in the non-revolving reducing term loan facility are set at \$820,000 per month resulting in the extinguishment of the facility on May 31, 2010. Debt under the facility, that includes bank debt and working capital deficiency but excludes the risk management contracts, future income taxes and asset retirement obligations, amounted to \$33.3 million at September 30, 2009. Included in debt under the facility is a U.S. \$10,000,000 (CAD - \$10,707,000) Libor based loan as at September 30, 2009.

Interest on the Company's revolving reducing term loan facility is at rates ranging from Canadian or US 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

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
(unaudited)

Three and nine months ended September 30, 2009

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## 4. Bank loan (continued):

non-revolving reducing term loan facility is at Canadian or US prime plus 3.00% on prime based loans and from the base rate plus 4.75% 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 September 30, 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.

## 5. Related party transactions:

A director of the Company is a partner in a law firm that periodically provides legal services to the Company. During the first nine months of 2009, the Company recorded a total of \$1,547 (2008 - \$nil) for legal fees and disbursements.

An officer of the Company is a partner in a law firm that provides legal services to the Company. During the first nine months of 2009, the Company recorded a total of \$118,902 (2008 - \$334,002) for legal fees and disbursements. As at September 30, 2009 accounts payable and accrued liabilities include \$42,720 (2008 - \$75,000) relating to these payments.

## 6. 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:

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
(unaudited)

Three and nine months ended September 30, 2009

## 6. Asset retirement obligations (continued):

Changes to the asset retirement obligations were as follows:

	Nine months ended September 30, 2009	Year ended December 31, 2008
Asset retirement obligations, beginning of period	\$ 14,498,062	\$ 3,697,721
Liabilities settled	(324,051)	(525,475)
Liabilities acquired	-	5,214,917
Liabilities disposed (note 3)	(2,330,981)	-
Liabilities incurred	6,654	521,277
Change in estimate	-	5,262,397
Foreign currency translation	(294,605)	-
Accretion expense	760,326	327,225
Asset retirement obligations, end of period	\$ 12,315,405	\$ 14,498,062

The total undiscounted amount of estimated cash flows required to settle the obligation at September 30, 2009 is \$27.6 million (December 31, 2008 - \$34.4 million), which has been discounted using a credit-adjusted risk free rate of 8.0% and an inflation factor of 1.5%. The majority of these obligations will be incurred between 2017 and 2022; however approximately \$7.3 million in obligations are not anticipated to be incurred until after 2030.

## 7. Convertible debentures:

In February 2009, the Company redeemed convertible debentures of \$3,480,000 assumed in a corporate acquisition in 2006. The equity component of \$370,000 which represents the value attributed to the holder's conversion right was reclassified to contributed surplus as a result of the redemption.

## 8. Shareholder's equity:

a) Authorized:

Unlimited number of common shares

Unlimited number of non-voting preferred shares, issuable in series, none of which have been issued.

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
(unaudited)

Three and nine months ended September 30, 2009

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

### b) Issued:

	Nine Months Ended September 30, 2009		Year Ended December 31, 2008	
	Number	Amount	Number	Amount
Common shares:				
Balance, beginning of period	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	–	–	1,249,300	787,059
Issued for cash pursuant to private placement of flow-through shares	8,750,000	3,500,000	5,555,555	4,000,000
Tax effect of flow-through shares	–	(1,040,000)	–	(1,356,625)
Share issue costs	–	(247,890)	–	(392,062)
Tax effect of share issue costs	–	66,475	–	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 period	109,961,890	\$ 95,760,026	101,249,646	\$ 93,515,925

### c) Flow-through shares:

In September 2009, the Company issued 8,750,000 flow-through 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 shares for gross proceeds of \$245,000. The terms of the share issue requires the Company to renounce to subscribers Canadian Exploration Expenses in the amount of \$3,500,000 by December 31, 2010.

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 March and April 2008, the Company issued 5,555,555 flow-through shares at \$0.72 per share for gross proceeds of \$4,000,000, for which officers of the Company subscribed for 34,000 flow-through shares for gross proceeds of \$24,480.

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
(unaudited)

Three and nine months ended September 30, 2009

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

### d) Per share amounts:

The following table details the per share amount and the weighted average number of common and diluted shares.

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Basic and diluted:				
Income (loss) per share basic and diluted	\$ (0.02)	\$0.11	\$ (0.08)	\$0.09
Shares outstanding:				
Basic	103,903,661	90,741,413	102,144,039	88,341,520
Diluted	103,903,661	91,212,175	102,144,039	88,724,513

In calculating the per share amounts for the period ended September 30, 2009, 8,127,000 (2008 – 2,990,000) options were excluded from the dilution calculation, as they were anti-dilutive.

### e) 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 September 30, 2009 and December 31, 2008 and the changes during those periods:

	Nine Months Ended		Year Ended	
	September 30, 2009		December 31, 2008	
	Number of options	Exercise price	Number of options	Exercise price
Balance, beginning of period	7,361,000	\$ 0.70	3,758,919	\$ 0.88
Granted	1,788,000	0.21	4,296,000	0.55
Exercised	-	-	(283,251)	0.32
Forfeited	(1,022,000)	0.94	(410,668)	1.01
Balance, end of period	8,127,000	\$ 0.56	7,361,000	\$ 0.70
Exercisable	4,366,666	\$ 0.77	3,962,334	\$ 0.86

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
(unaudited)

Three and nine months ended September 30, 2009

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

### e) Stock options (continued):

The following table summarizes information about the stock options outstanding and exercisable at September 30, 2009:

Range	Options Outstanding	Options Outstanding			Options Exercisable	
		Weighted Average Exercise Price	Weighted Average Remaining Term (years)	Exercisable	Weighted Average Exercise Price	
\$ 0.20 - 0.35	1,676,000	\$ 0.21	4.26	-	\$ -	
\$ 0.36 - 0.50	2,471,000	0.39	3.74	695,000	0.40	
\$ 0.51 - 0.70	1,650,000	0.60	3.10	1,600,000	0.60	
\$ 0.71 - 1.00	1,150,000	0.79	3.58	891,666	0.80	
\$ 1.01 - 2.00	1,180,000	1.18	1.17	1,180,000	1.18	
Total	8,127,000	\$ 0.56	3.32	4,366,666	\$ 0.77	

### f) Stock-based compensation:

Options granted to directors, officers and employees are accounted for using the fair value method. The fair value of stock options granted during 2009, which vest over 36 months, was \$414,242 (\$0.23 per option) (2008 – \$1,485,974 or \$0.57 per option) as estimated at the date of grant using the Black-Scholes option-pricing model with weighted average assumptions for the grant as follows:

	2009	2008
Risk free rate	1.46 – 2.56%	2.64 – 3.25%
Expected life	5 years	5 years
Expected volatility	91 - 152%	125 - 137%
Expected dividend	nil	nil
Expected forfeitures	nil	nil

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
(unaudited)

Three and nine months ended September 30, 2009

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

### g) Contributed surplus:

The change in the contributed surplus account is reconciled in the table below:

	Nine Months Ended September 30, 2009	Year Ended December 31, 2008
Balance, beginning of period	\$ 4,451,743	\$ 3,430,965
Stock-based compensation expense	750,047	824,263
Stock-based compensation capitalized	164,158	140,342
Reclassification of options exercised	-	(60,490)
Reclassification of equity component of debenture (note 7)	370,000	-
Unclaimed shares returned to treasury	34,484	-
Premium on NCIB (note 8(h))	-	116,663
Balance, end of period	\$ 5,770,432	\$ 4,451,743

### h) Normal course issuer bid:

In October 2008, the Company received approval for a normal course issuer bid (NCIB) program for the repurchase and cancellation of its common shares. The program was initiated in October 2008 to repurchase up to 4,539,307 of its common shares during the period from October 16, 2008 to October 15, 2009. Any purchases were to 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 160,000 shares at a cost of \$31,200. The stated value of these shares exceeded their cost by \$116,663 (see note 8(g)). This excess has been recorded to contributed surplus.

### i) Accumulated other comprehensive income:

	Nine Months Ended September 30, 2009	Year Ended December 31, 2008
Balance, beginning of period	\$ -	\$ -
Translation gains on foreign operations	(741,254)	-
Balance, end of period	\$ (741,254)	\$ -

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
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Three and nine months ended September 30, 2009

## 9. 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.

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

	As at September 30, 2009		As at December 31, 2008	
Total fair value consists of the following:				
Fair value, end of period - current portion	\$	766,020	\$	6,696,175
Fair value, end of period - long-term portion		68,287		2,349,629
<b>Total fair value, end of period</b>	<b>\$</b>	<b>834,307</b>	<b>\$</b>	<b>9,045,804</b>

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

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Fair value, beginning of period	\$ (458,610)	\$ (7,050,838)	\$ 9,045,804	\$ -
Change in fair value	1,402,041	9,718,287	978,624	3,300,438
Settlement paid (received)	(109,124)	(217,504)	(9,190,121)	(850,493)
<b>Fair value, end of period</b>	<b>\$ 834,307</b>	<b>\$ 2,449,945</b>	<b>\$ 834,307</b>	<b>\$ 2,449,945</b>

The Company had the following risk management contract outstanding as at September 30, 2009. Fair values are determined using external counterparty information, which is compared to observable market data.

Commodity Sold	Notional volume	Remaining Term	Pricing	Fair value
Natural Gas	1,000 GJ per day	Jan 1, 2010 - Dec 31, 2010	\$ 6.78 per GJ	\$ 375,317
Natural Gas	1,000 GJ per day	Nov 1, 2009 - Mar 31, 2010	5.50 per GJ	11,699
Oil	100 bbl per day	Oct 1, 2009 - Apr 30, 2010	72.60 per bbl	(93,310)
Oil	100 bbl per day	May 1, 2010 - Apr 30, 2011	79.50 per bbl	(55,821)
Oil	400 bbl per day	Oct 1, 2009 - Dec 31, 2009	81.50 per bbl	201,552
Oil	200 bbl per day	Jan 1, 2010 - Dec 31, 2010	85.05 per bbl	394,870
				<b>\$ 834,307</b>

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
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Three and nine months ended September 30, 2009

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

### a) Commodity price risk management (continued):

Commodity price sensitivity:

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Commodity Price		
Natural gas financial contracts (GJ)		516,000
Price Change	\$	0.10
<b>Sensitivity - natural gas revenue</b>	<b>\$</b>	<b>51,600</b>

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Commodity Price		
Oil financial contracts (barrels)		167,500
Price Change	\$	1.00
<b>Sensitivity - oil revenue</b>	<b>\$</b>	<b>167,500</b>

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### b) Fair value of financial instruments:

The fair values of financial assets and liabilities that are included in the balance sheet approximate their carrying amounts.

### c) Credit risk:

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

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

As at September 30, 2009 the Company's receivables consisted of \$2,004,743 (December 31, 2008 - \$1,055,623) from joint interest partners, \$3,428,096 (December 31, 2008 - \$3,224,180) of receivables from petroleum and natural gas marketers and \$290,393 (December 31, 2008 - \$1,570,566) of other receivables.

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

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
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Three and nine months ended September 30, 2009

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

### c) Credit risk (continued):

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 September 30, 2009 (December 31, 2008 - \$nil).

As at September 30, 2009 the Company considers its receivables to be aged as follows:

(\$Cdn.)

Aging	September 30, 2009
Not past due	4,174,776
Past due by less than 90 days	441,756
Past due by more than 90 days	1,106,700
<b>Total</b>	<b>5,723,232</b>

### 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 September 30, 2009, the Company had outstanding U.S. \$10,000,000 (CAD - \$10,707,000) 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 \$100,000 and comprehensive income or loss as the case may be by \$49,949.

### e) Interest rate risk:

The Company is exposed to interest rate risk to the extent that revolving demand loan is at a floating rate of interest. Based on \$33.4 million average bank loan outstanding over the three month period ended September 30, 2009, a 100 basis point (1%) change in the interest rate would increase or decrease interest expense for the three month period by \$84,067.

All debt is denominated in Canadian dollars, except for U.S. \$10,000,000 (CAD - \$10,707,000) 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.

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
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Three and nine months ended September 30, 2009

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

Management closely monitors cash flow requirements to ensure that it has sufficient cash on demand or borrowing capacity to meet operational and financial obligations. At September 30, 2009, the Company had a \$37.54 million credit facility (see note 4).

## 10. Capital management:

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

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

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

At September 30, 2009, the Company's debt to funds from operations ratio is 2.88 : 1. The ratio fluctuates quarterly based on the timing of the Company's capital expenditure program, operating activities and financing activities. The debt to forward funds from operations ratio at September 30, 2009 is higher than the corporate goal of 1 : 1 as established in the management strategy goals and guidelines. The Company acquired GEOCAN at close to the peak of the last commodity price cycle and, because the Company was under levered at the time, used primarily debt to complete the acquisition. Since the acquisition, there was a significant deterioration of commodity prices which have recovered somewhat recently. This price decline has resulted in much lower future cash flows resulting in an increase in the debt to forward funds from operations ratio. As prices increase and firm, management believes that the current ratio, while high is manageable and will reduce the ratio through prudent fiscal management of cash in-flows and capital expenditures. Additional equity may also be considered to further help with debt reduction.

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
(unaudited)

Three and nine months ended September 30, 2009

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## 10. Capital management (continued):

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 September 30, 2009, the Company has complied with this external financial 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.

	September 30, 2009
Bank loan	\$ 29,322,000
Working capital <i>(excluding risk management contracts and future income taxes)</i>	3,963,548
Total debt	33,285,548
Annualized funds flow	\$ 11,551,304
Net debt to annualized funds flow ratio	2.88

## 11. Supplemental cash flow information:

	September 30, 2009	September 30, 2008
Change in non-cash working capital items:		
Accounts receivable	\$ 127,137	\$ (4,819,982)
Prepaid expenses and deposits	(61,567)	-
Accounts payable and accrued liabilities	1,768,148	571,357
	1,833,718	(4,248,625)
Amounts relating to operating activities	(821,348)	(1,342,842)
Amounts relating to investing activities	2,706,018	(2,876,847)
Amounts relating to financing activities	(50,952)	(28,936)
	1,833,718	(4,248,625)
Interest and taxes paid:		
Taxes paid	\$ -	\$ 480,218
Interest paid	\$ 803,678	\$ 719,436

## 12. 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. Business risks and economic indicators are similar across all geographical regions.

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements (Continued)  
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Three and nine months ended September 30, 2009

## 12. Segmented information (continued):

2009 (\$ Cdn.)	Canada	U.S	Egypt	Total
Oil and gas revenue	20,152,263	6,708,345	-	26,860,608
Income (loss) before income taxes	(13,198,660)	1,796,217	-	11,402,443
Operating income	8,242,765	2,433,891	-	10,676,656
Property, plant and equipment (note 3)	100,080,736	9,797,022	-	109,877,758
Capital expenditures	2,258,758	4,721,115	-	6,979,873

2008 (\$ Cdn.)	Canada	U.S	Egypt	Total
Oil and gas revenue	33,700,544	10,054,066	-	43,754,610
Income (loss) before income taxes	9,581,690	620,758	(735,598)	9,466,850
Operating income	20,380,705	4,356,365	-	24,737,070
Property, plant and equipment (note 3)	62,311,818	4,660,045	-	66,971,863
Capital expenditures	15,986,817	1,123,922	-	17,110,739

## 13. Commitments and contingencies:

### a) Flow-through shares:

In connection with the issuance of flow-through shares in 2009, the Company incurred a commitment to incur \$3,500,000 of eligible expenditures by December 31, 2010. As at September 30, 2009, the Company had not incurred any of these eligible expenditures.

### 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:

	(\$CDN)
2009	165,935
2010	411,265
2011	338,602
2012	197,517

### 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 period of resolution.