Unaudited Interim Consolidated Financial Statements of

# ARSENAL ENERGY INC.

For the Quarter ended June 30, 2009

# ARSENAL ENERGY INC.

Interim Consolidated Balance Sheets
(unaudited)

| As at | June 30, 2009 | December 31, 2008 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 1,034,836 | $ 825,223 |
| Accounts receivable | 6,905,185 | 5,850,369 |
| Prepaid expenses and deposits | 792,126 | 556,804 |
| Risk management contracts (note 9) | - | 6,696,175 |
| Future income taxes | 123,965 | - |
| | 8,856,112 | 13,928,571 |
| Risk management contracts (note 9) | - | 2,349,629 |
| Reclamation bonds | 203,641 | 213,272 |
| Property, plant and equipment (note 3) | 113,426,393 | 127,232,156 |
| | $ 122,486,146 | $ 143,723,628 |
| **Liabilities and Shareholders' Equity** | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | $ 11,206,646 | $ 10,246,399 |
| Bank loan (note 4) | 34,630,000 | 42,002,004 |
| Risk management liability (note 9) | 308,912 | - |
| Convertible debentures (note 7) | - | 3,463,089 |
| Future income tax | - | 2,202,600 |
| | 46,145,558 | 57,914,092 |
| Risk management liability (note 9) | 149,698 | - |
| Asset retirement obligations (note 6) | 12,325,965 | 14,498,062 |
| Future income taxes | 10,203,403 | 10,605,500 |
| | 68,824,624 | 83,017,654 |
| Shareholders' Equity: | | |
| Common shares (note 8) | 92,475,925 | 93,515,925 |
| Contributed surplus (note 8(g)) | 5,473,610 | 4,451,743 |
| Common share conversion rights (note 7) | - | 370,000 |
| Accumulated other comprehensive loss (note 8(i)) | (348,948) | - |
| Deficit | (43,939,065) | (37,631,694) |
| | 53,661,522 | 60,705,797 |
| | $ 122,486,146 | $ 143,723,628 |

Future operations (note 1)
Commitments and contingencies (note 13)
Subsequent event (note 14)

See accompanying notes to interim consolidated financial statements.

# ARSENAL ENERGY INC.

Interim Consolidated Statements of Loss and Deficit
(unaudited)

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| **Revenue** | | | | |
| Oil and gas | $ 9,638,098 | $ 16,678,644 | $ 17,608,011 | $ 27,987,795 |
| Loss on risk management contracts (note 9) | (718,604) | (7,158,941) | (423,417) | (7,683,827) |
| Royalties | (1,790,227) | (3,127,671) | (3,589,625) | (5,204,454) |
| | 7,129,267 | 6,392,032 | 13,594,969 | 15,099,514 |
| Other income | 2,377 | 734 | 3,197 | 2,296 |
| | 7,131,644 | 6,392,766 | 13,598,166 | 15,101,810 |
| **Expenses** | | | | |
| Operating | 3,383,363 | 3,761,566 | 7,038,927 | 7,317,194 |
| Transportation | 222,134 | - | 433,508 | - |
| General and administrative | 1,080,918 | 455,363 | 2,045,134 | 1,726,736 |
| Finance charges and fees | 537,964 | 118,812 | 764,813 | 261,563 |
| Other expenses | 590,000 | 438,056 | 590,000 | 438,056 |
| Interest on convertible debentures | - | 69,030 | 34,323 | 138,439 |
| Foreign exchange (gain) loss | (900,359) | 414,284 | (1,104,428) | 391,247 |
| Convertible debenture accretion | - | 31,284 | 16,911 | 56,915 |
| Depletion, depreciation and accretion | 6,741,852 | 3,929,111 | 13,325,100 | 7,395,159 |
| Property, plant and equipment impairment (note 3) | - | - | - | 495,650 |
| Stock-based compensation (note 8(g)) | 273,634 | 192,050 | 538,559 | 301,976 |
| | 11,929,506 | 9,409,556 | 23,682,847 | 18,522,935 |
| Loss before income taxes | (4,797,862) | (3,016,790) | (10,084,681) | (3,421,125) |
| Income taxes: | | | | |
| Current income taxes | - | 266,659 | - | 614,509 |
| Future income tax (reduction) | (1,562,202) | (1,357,596) | (3,777,310) | (1,621,755) |
| | (1,562,202) | (1,090,937) | (3,777,310) | (1,007,246) |
| Net loss for the period | (3,235,660) | (1,925,853) | (6,307,371) | (2,413,879) |
| Deficit, beginning of period | (40,703,405) | (52,708,897) | (37,631,694) | (52,220,871) |
| Deficit, end of period | $ (43,939,065) | $ (54,634,750) | $ (43,939,065) | $ (54,634,750) |
| Loss per share, basic and diluted (note 8(d)) | $ (0.03) | $ (0.02) | $ (0.06) | $ (0.03) |

Interim Consolidated Statement of Comprehensive Loss
(unaudited)

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Net loss | $ (3,235,660) | $ (1,925,853) | $ (6,307,371) | $ (2,413,879) |
| Translation losses on foreign operations (note 8(i)) | (348,948) | - | (348,948) | - |
| Comprehensive loss | $ (3,584,608) | $ (1,925,853) | $ (6,656,319) | $ (2,413,879) |

See accompanying notes to interim consolidated financial statements.

# ARSENAL ENERGY INC.

Interim Consolidated Statements of Cash Flows
(unaudited)

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| **Cash provided by (used in):** | | | | |
| **Operations:** | | | | |
| Net loss for the period | $ (3,235,660) | $ (1,925,853) | $ (6,307,371) | $ (2,413,879) |
| Items not affecting cash: | | | | |
| Loss on risk management contracts | 718,604 | 6,574,725 | 423,417 | 7,050,838 |
| Non-cash general and administrative | - | 225,000 | - | 225,000 |
| Depletion, depreciation and accretion | 6,741,852 | 3,929,111 | 13,325,100 | 7,395,159 |
| Property, plant and equipment impairment | - | - | - | 495,650 |
| Future income tax expense (reduction) | (1,562,202) | (1,357,596) | (3,777,310) | (1,621,755) |
| Convertible debenture accretion | - | 31,284 | 16,911 | 56,915 |
| Stock-based compensation | 273,634 | 192,050 | 538,559 | 301,976 |
| Unrealized foreign exchange gain (loss) | (900,359) | 414,284 | (953,311) | 391,247 |
| Settlement of risk management contracts (note 9) | (4,147) | - | 9,080,997 | - |
| Asset retirement obligations settled | (101,322) | (32,487) | (354,464) | (40,928) |
| | 1,930,400 | 8,050,518 | 11,992,528 | 11,840,223 |
| Net change in non-cash working capital (note 11) | 2,066,235 | 298,511 | (1,017,908) | (2,382,479) |
| | 3,996,635 | 8,349,029 | 10,974,620 | 9,457,744 |
| **Financing:** | | | | |
| Bank loan (repayments) | (5,972,532) | (5,605,942) | (7,372,004) | (4,377,285) |
| Repayment of convertible debentures | - | - | (3,480,000) | - |
| Issue of shares for cash | - | 943,321 | - | 4,787,059 |
| Issued of shares for cash on exercise of stock options | - | 53,833 | - | 64,333 |
| Share issue expenses | - | (89,953) | - | (370,904) |
| Net change in non-cash working capital items (note 11) | (59,966) | (1,773,898) | (112,604) | (24,632) |
| | (6,032,498) | (6,472,639) | (10,964,608) | 78,571 |
| **Investing:** | | | | |
| Additions to property, plant and equipment | (1,139,845) | (4,792,985) | (3,714,906) | (9,677,825) |
| Purchase of property, plant and equipment | - | (974,733) | - | (974,733) |
| Disposition of property, plant and equipment | 2,326,749 | 1,225,792 | 3,166,124 | 1,235,792 |
| Net change in non-cash working capital items (note 11) | 1,383,933 | (2,665,536) | 800,621 | (119,549) |
| | 2,570,837 | (1,876,390) | 251,839 | (9,536,315) |
| Foreign exchange loss on cash held in foreign currency | (76,908) | - | (52,238) | - |
| Change in cash and cash equivalents during the period | 458,066 | - | 209,613 | - |
| Cash and cash equivalents, beginning of period | 576,770 | - | 825,223 | - |
| Cash and cash equivalents, end of period | $ 1,034,836 | $ - | $ 1,034,836 | $ - |

Supplemental information (note 11)

See accompanying notes to interim consolidated financial statements.

## 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 supports its activities and meet its obligations, and receiving the continued financial support from its lenders (note 4). As at June 30, 2009, the Company has debt and working capital deficiency totaling $37.1 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. 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 in the period they occur. This change was applied prospectively beginning April 1, 2009.

**1. Basis of presentation (continued):**

b) Accounting policies (continued):

*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.

*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 in order to make it more useful to Canadian entities adopting IFRS for the first time. One such exemption relating to full cost oil and gas accounting is expected to reduce the administrative burden in the transition from the current Canadian Accounting Guideline 16 (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 proviso that an impairment test, under IFRS standards, be conducted at the transition date.

Although the Company has not completed development of its IFRS changeover plan, when finalized it will include project structure and governance, resourcing and training, an analysis of key GAAP differences and a phased plan to assess accounting policies under IFRS as well as 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:

**2. Business acquisition (continued):**

| Net asset acquired at assigned values: | |
|---|---|
| Working capital deficiency | $ (2,846,608) |
| Bank debt | (11,040,973) |
| Risk management liability | (476,641) |
| Property, plant and equipment | 60,273,801 |
| Asset retirement obligation | (5,154,550) |
| Future income taxes | (1,884,348) |
| 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.

Amendments may be made to the purchase price equation as certain working capital estimates and balances are finalized.

**3. Property, plant and equipment:**

| | June 30, 2009 | December 31, 2008 |
|---|---|---|
| Petroleum and natural gas properties | $ 153,234,981 | $ 154,923,250 |
| Production equipment | 29,409,025 | 28,829,593 |
| | 182,644,006 | 183,752,843 |
| Office furniture, equipment, and other | 536,118 | 531,743 |
| | 183,180,124 | 184,284,586 |
| Accumulated depletion and depreciation | (69,753,731) | (57,052,430) |
| | $ 113,426,393 | $ 127,232,156 |

In Canada and the United States, all costs of unproved properties have been capitalized, and depleted during the first six months of 2009 and for 2008. Future development costs totaling $4,579,000 (December 31, 2008 - $4,400,000) in Canada and $4,200,000 (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.

**3. Property, plant and equipment (continued):**

For the period ended June 30, 2009, Arsenal capitalized direct general and administrative expenses of $175,800 (2008 - $183,935) and $113,308 (2008 - $48,122) of stock based compensation and $33,233 (2008 - $20,813) of future tax related thereto.

During 2009, the Company disposed of certain non-core properties for proceeds of approximately $3.2 million. In addition, the Company disposed of asset retirement obligations relating to the properties sold of approximately $2.23 million.

**4. Bank loan:**

At June 30, 2009, the Company had a $40.0 million credit facility consisting of a demand revolving operating loan facility in the amount of $31.0 million and a non-revolving reducing term loan facility in the amount of $9.0 million. 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 commencing July 31, 2009, 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 and future income tax (whether assets or liabilities) amounted to $37.1 million at June 30, 2009. Included in debt under the facility is a U.S. $10,000,000 (CAD - $11,630,000) Libor based loan as at June 30, 2009.

Interest on the Company's non-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 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, as defined in the agreement, (funds flow for the last quarter annualized) ratio.

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 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.

The Company is in compliance with its bank covenants at June 30, 2009.

**5. Related party transactions:**

An officer of the Company is a partner in a law firm that provides legal services to the Company. During the first six months of 2009, the Company recorded a total of $44,783 (2008 - $267,524) for legal fees and disbursements. As at June 30, 2009 accounts payable and accrued liabilities include $12,500 (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:

Changes to the asset retirement obligations were as follows:

| | Six months ended June 30, 2009 | Year ended December 31, 2008 |
|---|---|---|
| Asset retirement obligations, beginning of period | $ 14,498,062 | $ 3,697,721 |
| Liabilities settled | (354,464) | (525,475) |
| Liabilities acquired | - | 5,214,917 |
| Liabilities disposed (note 3) | (2,231,849) | - |
| Liabilities incurred | 2,970 | 521,277 |
| Change in estimate | - | 5,262,397 |
| Foreign currency translation | (111,484) | - |
| Accretion expense | 522,730 | 327,225 |
| Asset retirement obligations, end of period | $ 12,325,965 | $ 14,498,062 |

The total undiscounted amount of estimated cash flows required to settle the obligation at June 30, 2009 is $37.1 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% for both periods. 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

b) Issued:

| | Six Months Ended June 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 | – | – | 5,555,555 | 4,000,000 |
| Tax effect of flow-through shares | – | (1,040,000) | – | (1,356,625) |
| Share issue costs | – | – | – | (392,062) |
| Tax effect of share issue costs | – | – | – | 127,425 |
| Allocated from contributed surplus | – | – | – | 60,490 |
| Normal course issuer bid | – | – | (160,000) | (147,863) |
| Balance, end of period | 101,249,646 | $ 92,475,925 | 101,249,646 | $ 93,515,925 |

c) Flow-through shares:

In March and April 2008, the Company issued 5,555,555 flow-through shares at $0.72 per share for gross proceeds of $4,000,000, for which officers of the Company subscribed for 34,000 flow-through shares for gross proceeds of $24,480. The terms of the share issue requires the Company to renounce to subscribers Canadian Exploration Expenses in the amount of $4,000,000 which have been incurred.

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

d) Per share amounts:

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

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Basic and diluted: | | | | |
| Loss per share basic and diluted | $ (0.03) | $(0.02) | $ (0.06) | $(0.03) |
| Shares outstanding: | | | | |
| Basic | 101,249,646 | 90,073,484 | 101,249,646 | 86,606,456 |
| Diluted | 101,249,646 | 90,453,104 | 101,249,646 | 86,915,724 |

In calculating the per share amounts for the period ended June 30, 2009, 8,399,000 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 June 30, 2009 and December 31, 2008 and the changes during those periods:

| | Six Months Ended June 30, 2009 | | Year Ended 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 | 1,688,000 | 0.21 | 4,296,000 | 0.55 |
| Exercised | - | - | (283,251) | 0.32 |
| Forfeited | (650,000) | 1.12 | (410,668) | 1.01 |
| Balance, end of period | 8,399,000 | $ 0.57 | 7,361,000 | $ 0.70 |
| Exercisable | 4,290,000 | $ 0.77 | 3,962,334 | $ 0.86 |

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

e) Stock options (continued):

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

| | | | Options outstanding | | | Options exercisable |
|---|---|---|---|---|---|---|
| Range ($) | Options Outstanding | | Weighted average exercise price | Weighted average remaining terms (years) | Exercisable | | Weighted average exercise price |
| $ 0.20 - 0.59 | 4,461,000 | $ | 0.33 | 3.85 | 1,085,000 | $ | 0.45 |
| $ 0.60 - 1.10 | 3,048,000 | | 0.73 | 3.53 | 2,315,000 | | 0.74 |
| $ 1.11 - 1.25 | 735,000 | | 1.19 | 1.18 | 735,000 | | 1.19 |
| $ 1.26 - 2.00 | 155,000 | | 1.37 | 1.21 | 155,000 | | 1.37 |
| Total | 8,399,000 | $ | 0.57 | 3.45 | 4,290,000 | $ | 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 $389,025 ($0.23 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% | 2.64 – 3.25% |
| Expected life | 5 years | 5 years |
| Expected volatility | 152% | 125 - 137% |
| Expected dividend | nil | nil |
| Expected forfeitures | nil | nil |

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

g) Contributed surplus:

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

| | Six Months Ended June 30 2009 | Year Ended December 31 2008 |
|---|---|---|
| Balance, beginning of period | $ 4,451,743 | $ 3,430,965 |
| Stock-based compensation expensed | 538,559 | 824,263 |
| Stock-based compensation capitalized | 113,308 | 140,342 |
| Reclassification of options exercised | - | (60,490) |
| Reclassification of equity component of debenture (note 7) | 370,000 | - |
| Premium on NCIB (note 8(h)) | - | 116,663 |
| Balance, end of period | $ 5,473,610 | $ 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 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 has not repurchased 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:

| | Six Months Ended June 30, 2009 | Year Ended December 31, 2008 |
|---|---|---|
| Balance, beginning of period | $ - | $ - |
| Translation losses on self-sustaining operations | (348,948) | - |
| Balance, end of period | $ (348,948) | $ - |

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

| | As at June 30, 2009 | As at December 31, 2008 |
|---|---|---|
| Total fair value consists of the following: | | |
| Fair value, end of period - current portion | $ (308,912) | $ 6,696,175 |
| Fair value, end of period - long-term portion | (149,698) | 2,349,629 |
| Total fair value, end of period | $ (458,610) | $ 9,045,804 |

| | Three Months Ended June 30 2009 | Three Months Ended June 30 2008 | Six Months Ended June 30 2009 | Six Months Ended June 30 2008 |
|---|---|---|---|---|
| Fair value, beginning of period | $ 255,847 | $ (476,113) | $ 9,045,804 | $ - |
| Changes in fair value | (718,604) | (7,158,941) | (423,417) | (7,683,827) |
| Settlement paid (received) | 4,147 | 584,216 | (9,080,997) | 632,989 |
| Fair value, end of period | $ (458,610) | $ (7,050,838) | $ (458,610) | $ (7,050,838) |

The Company had the following risk management contract outstanding as at June 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 | $ 356,389 |
| Natural Gas | 1,000 GJ per day | Nov 1, 2009 - Mar 31, 2010 | 5.50 per GJ | 21,803 |
| Oil | 100 bbl per day | July 1, 2009 - Apr 30, 2010 | 72.60 per bbl | (360,873) |
| Oil | 100 bbl per day | May 1, 2010 - Apr 30, 2011 | 79.50 per bbl | (327,015) |
| Oil | 400 bbl per day | Aug 1, 2009 - Dec 31, 2009 | 81.50 per bbl | (148,914) |
| | | | | $ (458,610) |

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

a) Commodity price risk management (continued):

Commodity price sensitivity:

| Commodity Price | | |
|---|---|---|
| Natural Gas Hedged Production (Mcf) | | 426,200 |
| Price Change | $ | 0.10 |
| **Sensitivity - natural gas revenue** | **$** | **42,620** |

| Commodity Price | | |
|---|---|---|
| Oil hedged production (barrels) | | 128,100 |
| Price Change | $ | 1.00 |
| **Sensitivity - oil revenue** | **$** | **128,100** |

b) Fair value of financial instruments:

The Company's exposure under its financial instruments is limited to financial assets and liabilities, all of which are included in these financial statements. The fair values of financial assets 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 meets 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 June 30, 2009 the Company's receivables consisted of $1,399,484 (December 31, 2008 - $1,055,623) from joint interest partners, $4,067,479 (December 31, 2008 - $3,224,180) of receivables from petroleum and natural gas marketers and $1,438,222 (December 31, 2008 - $1,570,566) of other receivables of which $234,764 is refundable from US tax authorities and was received in Q3 2009.

Receivables from petroleum and natural gas marketers are normally collected on the 25$^{th}$ 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

**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 June 30, 2009 (December 31, 2008 - $nil).

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 June 30, 2009, the Company had outstanding U.S. $10,000,000 (CAD - $11,630,000) 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 by $121,700.

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 $34.9 million average bank loan outstanding over the three month period ended June 30, 2009, a 100 basis point (1%) change in the interest rate would increase or decrease interest expense for the three month period by $87,250.

All debt is denominated in Canadian dollars, except for U.S. $10,000,000 (CAD - $11,630,000) 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 obligations over the next two years. At June 30, 2009, the Company had a $40.0 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 flow ratio, a non-GAAP financial measure. Debt includes bank debt plus or minus working capital. Annualized funds flow is calculated as cash flow from operations before changes in non-cash working capital 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 June 30, 2009, the Company's debt to funds flow ratio is 4.57 : 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 cash flow ratio at June 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 cash flow 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. An equity issue may be considered to further help with debt reduction.

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

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

**10. Capital management (continued):**

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

| | | June 30, 2009 |
|---|---|---|
| Bank loan | $ | 34,630,000 |
| Working capital | | |
| *(excluding risk management contracts and future income taxes)* | | 2,474,499 |
| Total debt | | 37,104,499 |
| | | |
| Annualized funds flow | $ | 8,126,888 |
| Net debt to annualized funds flow ratio | | 4.57 |

**11. Supplemental cash flow information:**

| | June 30, 2009 | June 30, 2008 |
|---|---|---|
| Change in non-cash working capital items: | | |
| Accounts receivable | $ (1,054,816) | $ (3,833,078) |
| Prepaid expenses and deposits | (235,322) | – |
| Accounts payable and accrued liabilities | 960,247 | 1,306,418 |
| | (329,891) | (2,526,660) |
| Amounts relating to operating activities | (1,017,908) | (2,382,479) |
| Amounts relating to investing activities | 800,621 | (119,549) |
| Amounts relating to financing activities | (112,604) | (24,632) |
| | (329,891) | (2,526,660) |
| Interest and taxes paid: | | |
| Taxes paid | $ – | $ 400,000 |
| Interest paid | $ 197,314 | $ 732,145 |

**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.

**12. Segmented information (continued):**

| 2009 ($ Cdn.) | Canada | U.S | Egypt | Total |
|---|---|---|---|---|
| Oil and gas revenue | 13,869,115 | 3,738,896 | - | 17,608,011 |
| Income (loss) before income taxes | (11,394,889) | 1,310,208 | - | (10,084,681) |
| Operating income | 5,481,861 | 1,064,090 | - | 6,545,951 |
| Property, plant and equipment (note 3) | 104,960,294 | 8,466,099 | - | 113,426,393 |
| Capital expenditures | 1,649,688 | 2,065,218 | - | 3,714,906 |

| 2008 ($ Cdn.) | Canada | U.S | Egypt | Total |
|---|---|---|---|---|
| Oil and gas revenue | 21,404,756 | 6,583,039 | - | 27,987,795 |
| Income (loss) before income taxes | 1,473,526 | (3,855,131) | (1,039,519) | (3,421,124) |
| Operating income | 12,442,114 | 2,391,045 | - | 14,833,159 |
| Property, plant and equipment (note 3) | 59,596,372 | 3,715,157 | - | 63,311,529 |
| Capital expenditures | 9,638,249 | 34,574 | 5,002 | 9,677,825 |

**13. Commitments and contingencies:**

a) Flow-through shares:

In connection with the issuance of flow-through shares in 2008, the Company incurred a commitment to incur $4,000,000 of eligible expenditures by December 31, 2009. As at June 30, 2009, the Company had incurred all of the eligible expenditures.

b) Office leases and equipment:

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 | 326,507 |
| 2010 | 651,278 |
| 2011 | 632,192 |
| 2012 | 368,779 |

c) Outstanding lawsuits:

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

## 14. Subsequent event:

On August 11, 2009, the Company entered into a crude oil commodity price contract, to sell 200 barrels of production per day from January 1, 2010 until December 31, 2010 at a price of $85.05 Canadian per barrel.