

Consolidated Financial Statements of

ARSENAL ENERGY INC.

Years ended December 31, 2010 and 2009

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 tests 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 22, 2011

INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the accompanying consolidated financial statements of Arsenal Energy Inc., which comprise the consolidated balance sheets as at December 31, 2010 and 2009, the consolidated statements of operations and deficit, comprehensive loss, and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Arsenal Energy Inc. as at December 31, 2010 and 2009, 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 22, 2011

ARSENAL ENERGY INC.

Consolidated Balance Sheets

As at	December 31, 2010	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,448,009	\$ 1,325,915
Accounts receivable	8,099,902	6,470,045
Prepaid expenses and deposits	398,009	532,808
Future income tax (note 9)	288,069	-
Risk management contracts (note 14(a))	-	126,749
	10,233,989	8,455,517
Reclamation deposit (note 7)	149,190	157,650
Property, plant and equipment (note 5 and 6)	103,229,339	108,267,249
	\$113,612,518	\$116,880,416
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 17,320,820	\$ 14,778,189
Bank loan (note 8)	11,412,875	22,290,000
Risk management contracts (note 14(a))	993,344	-
Future income tax (note 9)	-	36,757
	29,727,039	37,104,946
Risk management contracts (note 14(a))	427,169	123,371
Asset retirement obligations (note 11)	12,465,634	14,044,639
Future income taxes (note 9)	4,071,145	7,860,589
	46,690,987	59,133,545
Shareholders' Equity:		
Common shares (note 12(b))	117,126,441	100,955,986
Contributed surplus (note 13(b))	6,905,561	5,980,601
Accumulated other comprehensive loss	(753,184)	(507,506)
Deficit	(56,357,287)	(48,682,210)
	66,921,531	57,746,871
	\$113,612,518	\$ 116,880,416

Segmented information (note 17)

Commitments and contingencies (note 18)

Subsequent events (notes 14(a) and 19)

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

	2010	2009
Revenue		
Oil and gas	\$ 43,665,720	\$ 36,941,862
Realized gain on risk management contract (note 14(a))	1,788,624	166,107
Unrealized gain (loss) on risk management contracts (note 14(a))	(1,423,891)	3,378
Royalties	(7,826,810)	(6,784,823)
	36,203,643	30,326,524
Other income	19,507	31,097
	36,223,150	30,357,621
Expenses		
Operating	14,042,198	13,684,848
Transportation	819,054	1,084,061
General and administrative	3,586,124	4,027,721
Finance charges and fees (note 8)	1,019,755	1,590,176
Other expenses	-	1,351,064
Interest on convertible debentures (note 10)	-	34,323
Foreign exchange gain	(13,828)	(1,596,590)
Convertible debenture accretion	-	16,911
Depletion, depreciation and accretion	28,581,552	26,023,517
Stock-based compensation (note 13(a))	817,239	912,571
	48,852,094	47,128,602
Loss before income taxes	(12,628,944)	(16,770,981)
Income taxes:		
Future income tax reduction (note 9)	4,953,867	5,720,465
Net loss for the year	(7,675,077)	(11,050,516)
Deficit, beginning of year	(48,682,210)	(37,631,694)
Deficit, end of year	\$ (56,357,287)	\$ (48,682,210)
Loss per share, basic and diluted (note 12(d))	\$ (0.06)	\$ (0.11)

Consolidated Statement of Comprehensive Loss

	2010	2009
Net loss for the year	\$ (7,675,077)	\$ (11,050,516)
Translation losses on foreign operations	(245,678)	(507,506)
Comprehensive loss	\$ (7,920,755)	\$ (11,558,022)

See accompanying notes to consolidated financial statements.

ARSENAL ENERGY INC.

Consolidated Statements of Cash Flows

Years ended December 31

	2010	2009
Cash provided by (used in):		
Operations:		
Net loss for the year	\$(7,675,077)	\$(11,050,516)
Items not affecting cash:		
Unrealized (gain) loss on risk management contracts	1,423,891	(3,378)
Non-cash general and administrative and other expenses	63,374	504,580
Depletion, depreciation and accretion	28,581,552	26,023,517
Future income tax reduction	(4,953,867)	(5,720,465)
Convertible debenture accretion	-	16,911
Stock-based compensation	817,239	912,571
Unrealized foreign exchange (gain) loss	38,511	(1,188,404)
Settlement of risk management contracts (note 14(a))	-	9,211,912
Asset retirement obligations settled	(1,083,838)	(558,798)
	17,211,785	18,147,930
Net change in non-cash working capital (note 16)	(4,042,960)	(45,587)
	13,168,825	18,102,343
Financing:		
Bank loan (repayments)	(12,872,700)	(19,712,004)
Bank loan advance	2,268,985	-
Repayment of convertible debentures	-	(3,480,000)
Issue of shares for cash	19,598,550	9,000,000
Issue of shares on exercise of stock options	79,150	-
Repurchase of shares	(1,154,416)	-
Share issue expenses	(1,518,404)	(665,580)
Net change in non-cash working capital items (note 16)	56,839	(60,270)
	6,458,004	(14,917,854)
Investing:		
Additions to property, plant and equipment	(28,042,311)	(10,471,357)
Disposition of property, plant and equipment (note 5)	5,919,077	4,121,234
Acquisition of property	(2,259,529)	(479,084)
Net change in non-cash working capital items (note 16)	5,033,695	4,276,651
	(19,349,068)	(2,552,556)
Foreign exchange loss on cash held in foreign currency	(155,667)	(131,241)
Change in cash and cash equivalents during the year	122,094	500,692
Cash and cash equivalents, beginning of year	1,325,915	825,223
Cash and cash equivalents, end of year	\$ 1,448,009	\$ 1,325,915

Supplemental information (note 16)

See accompanying notes to consolidated financial statements.

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2010 and 2009

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 ("U.S."). Each country in which Arsenal conducts business has been treated as an identifiable reporting segment, refer to note 17 for additional disclosures. All amounts are reported in Canadian dollars unless otherwise noted.

2. 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 earnings, and renewals and enhancements, which extend the economic life of the property, plant and equipment, are capitalized. Gains and losses are not recognized upon disposition of oil and natural gas properties unless such a disposition would alter the rate of depletion by at least 20%.

c) Ceiling test:

A ceiling test is performed at least annually to assess the carrying value of oil and gas assets. A cost center is defined on a country by country basis, and is tested for recoverability using undiscounted future cash flows from proved reserves and forward indexed commodity prices, adjusted for contractual obligations and product quality differentials. A cost center is written down to its fair value when its carrying value, 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 recorded to earnings 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

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

2. Significant accounting policies (continued):

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.

h) Use of estimates:

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.

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

2. Significant 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. 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 and bank loan 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 are not designated as hedges and are recorded as a risk management contract asset or a risk management contract liability on the consolidated balance sheet with any changes in fair value during the period recognized in earnings.

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.

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

3. Change in accounting policies:

Future Accounting Changes

International Financial Reporting Standards ("IFRS")

Effective January 1, 2011, the Company will be required to report its Consolidated Financial Statements in accordance with IFRS, including 2010 comparative information. Arsenal is in the final stages of its IFRS changeover plan and will report its first quarter 2011 results in accordance with IFRS. The transition from Canadian GAAP to IFRS is significant with differences affecting the financial position and results of operations.

4. Related party transactions:

An officer of the Company is a partner in a law firm that provides legal services to the Company. In 2010, the Company incurred a total of \$262,265 (2009 - \$ 158,887) for legal fees and disbursements. As at December 31, 2010, accounts payable include \$35,000 (2009 - \$42,232) relating to these payments.

A Director of the Company is a partner in a law firm that provides legal services to the Company. In 2010, the Company recorded a total of \$2,473 (2009 - \$3,484) for legal fees and disbursements. As at December 31, 2010 accounts payable include \$nil (2009 - \$nil) relating to these payments.

5. Property, plant and equipment:

	2010	2009
Petroleum and natural gas properties	\$ 177,095,475	\$ 159,328,416
Production equipment	34,370,565	30,002,163
	211,466,040	189,330,579
Office furniture, equipment and other	513,059	443,343
	211,979,099	189,773,922
Accumulated depletion and depreciation	(108,749,760)	(81,506,673)
	\$ 103,229,339	\$ 108,267,249

In Canada and the U.S., the costs of acquisition and evaluation of unproved properties have been capitalized but excluded from depletion. The costs of unproved properties excluded in Canada from depletion were \$3,495,889 (2009 - \$nil) none were excluded in the US from depletion. Future salvage values of \$3,814,089 (2009 -\$4,091,322) in Canada and \$315,140 (2009 - \$304,192) in the U.S. were also excluded from the depletion calculation. Future development costs totaling \$1,964,900 (2009 - \$2,552,700) in Canada and \$33,288,600 (2009 - \$27,546,395) in the U.S. were included in the depletion calculation.

For the year ended December 31, 2010, Arsenal capitalized direct general and administrative expenses of \$532,000 (2009 - \$351,600) and \$166,172 (2009 - \$211,803) of stock based compensation and \$58,993 (2009 - \$75,193) of future tax related thereto.

During 2010, the Company disposed of certain non-core properties for proceeds of \$5,919,077 (2009 - \$4,121,234). In addition, the Company disposed of asset retirement obligations relating to the properties sold of approximately \$1,840,048 (2009 -\$2,541,950).

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

6. Ceiling test:

On December 31, 2010 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, 2010 were as follows:

Benchmark reference price forecast	2011	2012	2013	2014	2015	2016	2017	2018
WTI (\$US/bbl)	85.00	89.25	91.55	95.50	102.85	110.40	112.60	114.85
Edmonton Par (\$CDN/bbl)	82.80	88.80	94.05	98.15	105.80	113.70	116.05	118.35
Bow River Hardisty (\$CDN/bbl)	71.10	75.50	79.05	81.35	87.10	93.90	95.15	96.35
AECO-C (\$CDN/mcf)	4.10	4.60	5.20	5.50	5.75	6.20	6.55	7.00
Edmonton Butanes (\$CDN/bbl)	70.40	75.50	79.95	83.45	89.95	96.65	98.65	100.60
Edmonton Pentanes (\$CDN/bbl)	86.95	93.25	98.75	103.05	111.10	119.40	121.85	124.25
Exchange rate (\$CDN/\$US)	1.00	0.98	0.95	0.95	0.95	0.95	0.95	0.95

After 2018 the price forecast escalates at 2% per year to the end of the reserve life and the exchange rate remains constant at 0.95.

Pursuant to the ceiling test calculations, the Company concluded that no impairment existed as at December 31, 2010 and 2009.

7. Reclamation deposit:

At December 31, 2010 the Company had \$149,190 (2009 - \$157,650) or \$150,000 USD on deposit with the State of North Dakota government for future site reclamation activities. These funds will remain on deposit until the Company abandons and reclaims well sites in the U.S..

8. Bank loan:

At December 31, 2010, the Company had a \$40,000,000 credit facility consisting of a demand revolving operating loan facility of which \$11,412,875 (2009 - \$22,290,000) had been drawn. The facility can be utilized in either Canadian or U.S. dollars.

Included in debt under the facility at December 31, 2010, is a U.S. \$5,000,000 (CAD - \$4,973,000) Libor based loan and a U.S. \$1,875,000 (CAD - \$1,864,875) Demand based loan.

At December 31, 2009, the Company had a non-revolving reducing term loan facility in the amount of \$4,080,000 requiring reductions of \$820,000 per month. On January 29, 2010, the Company repaid its non-revolving reducing term loan.

The credit facility at December 31, 2010 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 U.S. subsidiary in the form of a Mortgage Security Agreement and Letter of Undertaking limited to \$20,400,000.

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 and from the base rate plus 2.75% to 3.75% on guaranteed notes and Libor based loans.

The interest rate is set based on the Company's current debt, as calculated for this purpose to include bank debt plus working capital and excludes asset retirement obligations and risk management contracts (whether an asset or an obligation) and the income taxes related thereto, to trailing funds flow ratio (funds flow for the current quarter annualized).

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

8. Bank loan (continued):

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

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

The Company is in compliance with its bank covenants at December 31, 2010.

The amount of the facility is subject to a borrowing base test performed annually, primarily based on reserves, using commodity prices estimated by the lender, as well as other factors. The next annual review date has been set for May 31, 2011, but may be set at an earlier or later date at the sole discretion of the lender.

During 2010, the Company incurred interest on its credit facilities in the amount of \$688,172 (2009 - \$1,116,505).

9. Income taxes:

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

	2010	2009
Loss before income taxes	\$ (12,628,944)	\$ (16,770,981)
Combined federal and provincial tax rate	28.11%	29.17%
Expected tax provision (reduction)	(3,549,996)	(4,892,095)
Increase (decrease) in taxes resulting from:		
Stock-based compensation	229,686	266,216
Change in tax rates	(113,304)	337,729
Tax impact of foreign jurisdictions	460,665	64,187
Income tax adjustments ¹	(1,987,182)	(1,840,330)
Foreign exchange	-	226,016
Change in valuation allowance	-	28,125
Other	6,264	89,687
	\$ (4,953,867)	\$ (5,720,465)

¹ Income tax adjustment reflect changes to the estimates of the Company's income tax accounts.

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

9. Income taxes (continued):

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

	2010	2009
Future tax liability (asset):		
Property, plant and equipment	\$ 13,249,355	\$ 16,834,000
Share issue costs	(487,780)	(503,550)
Asset retirement obligations	(3,468,938)	(3,917,743)
Unrealized foreign exchange gain	639,445	694,404
Unrealized gain on commodity contracts	(429,766)	(55,460)
Non-capital losses	(5,619,027)	(5,146,927)
Net capital losses	(897,046)	(897,046)
Valuation allowance	897,046	897,046
Other	(100,213)	(7,378)
Net future income tax liability	\$ 3,783,076	\$ 7,897,346

The Company has non-capital losses of approximately \$20.6 million as at December 31, 2010 that expire between 2012 and 2030.

10. 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 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. Accretion recorded to February 15, 2009 totaled \$16,911.

11. 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 Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

11. Asset retirement obligations (continued):

Changes to the asset retirement obligations were as follows:

	2010		2009	
Asset retirement obligations, beginning of year	\$	14,044,639	\$	14,498,062
Liabilities settled		(1,083,838)		(558,798)
Liabilities acquired		13,264		208,769
Liabilities disposed (note 5)		(1,840,048)		(2,541,950)
Liabilities incurred		424,107		134,476
Change in estimate		-		1,619,119
Foreign currency translation		(146,023)		(343,818)
Accretion expense		1,053,533		1,028,779
Asset retirement obligations, end of year	\$	12,465,634	\$	14,044,639

The total undiscounted amount of estimated cash flows required to settle the obligation is \$32,153,050 (2009 - \$35,482,345), which has been discounted using a credit-adjusted risk free rate of 8.0% (2009 - 8.0%) and an inflation factor of 1.5% (2009 - 1.5%). The majority of these obligations will be incurred between 2012 and 2022; however approximately \$5,300,000 in obligations are not anticipated to be incurred until after 2030.

12. Shareholder's equity:

a) Authorized:

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

b) Issued:

	December 31, 2010		December 31, 2009	
	Number	Amount	Number	Amount
Common shares:				
Balance, beginning of year	120,461,890	\$ 100,955,986	101,249,646	\$ 93,515,925
Issued on exercise of options	171,500	79,150	-	-
Common shares issued	11,283,000	9,590,550	8,000,000	4,000,000
Flow-through common shares issued	10,300,000	10,008,000	11,250,000	5,000,000
Tax effect of flow-through shares	-	(1,250,000)	-	(1,040,000)
Share issue costs	-	(1,548,404)	-	(665,580)
Tax effect of share issue costs	-	387,125	-	180,125
Unclaimed shares returned to treasury	-	-	(37,756)	(34,484)
Allocated from contributed surplus	-	65,318	-	-
Normal course issuer bid	(1,403,918)	(1,161,284)	-	-
Balance, end of year	140,812,472	\$ 117,126,441	120,461,890	\$ 100,955,986

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

12. Shareholder's equity (continued):

Common Shares

On February 26, 2010, the Company issued 11,283,000 common shares at \$0.85 per share for gross proceeds of \$9,590,550.

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).

c) Flow-through shares:

On October 7, 2010, the Company issued 7,300,000 flow-through common shares at \$0.96 per share for gross proceeds of \$7,008,000, for which directors and officers of the Company subscribed for 79,500 flow-through common shares for gross proceeds of \$76,320. The terms of the share issue requires the Company to incur Canadian Exploration Expenses in the amount of \$7,008,000 by December 31, 2011. As at December 31, 2010, approximately \$1,300,000 in exploration costs had been incurred requiring approximately \$5,700,000 to be incurred by December 31, 2011.

On February 26, 2010, the Company issued 3,000,000 flow-through common shares at \$1.00 per share for gross proceeds of \$3,000,000, for which directors and officers of the Company subscribed for 59,000 flow-through common shares for gross proceeds of \$59,000. The terms of the share issue require the Company to incur Canadian Exploration Expenses in the amount of \$3,000,000 by December 31, 2011. As at December 31, 2010, all exploration costs had been incurred on this issuance.

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 to incur Canadian Exploration Expenses in the amount of \$1,500,000 by December 31, 2010. As at December 31, 2010, all 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 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, 2010, all exploration cost had been incurred on this issuance.

d) Per share amounts:

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

	2010	2009
Basic and diluted:		
Loss per share basic and diluted	\$ (0.06)	\$ (0.11)
Shares outstanding:		
Basic	133,802,977	104,546,073
Diluted	133,802,977	104,546,073

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Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

12. Shareholder's equity (continued):

In calculating the diluted loss per share for the year ended December 31, 2010, 12,754,500 (2009 – 9,322,000) options were excluded from the dilution calculation, as they were anti-dilutive.

e) Normal course issuer bid:

In May 2010, the Company announced it had received approval for a normal course issuer bid ("NCIB") commencing May 31, 2010 and ending May 30, 2011. A total of 6,740,767 common shares may be acquired under the bid representing 5% of the 134,815,340 common shares outstanding as of May 20, 2010. As at December 31, 2010, the Company had acquired 1,403,918 common shares under the bid at a cost of \$1,154,416. The stated value of these shares exceeded their cost by \$6,867 and has been recorded to contributed surplus. (see note 13(b))

13. 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, 2010 and December 31, 2009 and the changes during those years:

	December 31, 2010		December 31, 2009	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Balance, beginning of year	9,322,000	\$ 0.55	7,361,000	\$ 0.70
Granted	4,280,000	0.88	3,133,000	0.31
Exercised	(171,500)	0.46	-	-
Expirations	(640,000)	1.23	(150,000)	0.59
Forfeited	(36,000)	0.37	(1,022,000)	0.94
Balance, end of year	12,754,500	\$ 0.62	9,322,000	\$ 0.55
Exercisable, end of year	5,860,500	\$ 0.57	4,991,999	\$ 0.73

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Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

13. Stock options (continued):

The following table summarizes information about the stock options outstanding and exercisable at December 31, 2010:

Range of exercise prices	Options outstanding			Options exercisable		
	Number of options	Weighted average exercise price	Weighted average remaining life (years)	Number of options	Weighted average exercise price	
\$0.20 to \$0.35	1,658,000	\$ 0.21	3.00	548,666	\$ 0.21	
\$0.36 to \$0.50	3,680,500	0.40	3.00	2,175,834	0.40	
\$0.51 to \$0.70	1,446,000	0.60	2.15	1,446,000	0.60	
\$0.71 to \$1.00	5,430,000	0.86	3.98	1,150,000	0.79	
\$1.01 to \$1.15	540,000	1.11	0.53	540,000	1.11	
Total	12,754,500	\$ 0.62	3.22	5,860,500	\$ 0.57	

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 2010 was \$2,586,615 (\$0.60 per option) (2009 - \$828,856 (\$0.26 per option)) as estimated at the date of grant using the Black-Scholes option-pricing model with weighted average assumptions for grants as follows:

	2010	2009
Risk free rate	2.05 - 2.90%	1.46 - 2.88%
Expected life	5 years	5 years
Expected volatility	86 - 87%	89 - 152%
Expected dividend	nil	nil
Expected forfeitures	nil	nil

b) Contributed surplus:

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

	2010	2009
Balance, beginning of year:	\$ 5,980,601	\$ 4,451,743
Stock-based compensation expensed	817,239	912,571
Stock-based compensation capitalized	166,172	211,803
Reclassification of options exercised	(65,318)	-
Premium on NCIB (note 12(e))	6,867	-
Reclassification of equity component of debenture (note 10)	-	370,000
Unclaimed shares returned to treasury	-	34,484
Balance, end of year	\$ 6,905,561	\$ 5,980,601

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Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

14. Risk management contracts 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 U.S. dollar but 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 uses derivative instruments as part of its risk management approach to manage commodity price fluctuations and stabilize funds from operations available for future development.

As at December 31, 2010, the Company has six crude oil swaps in-place fixing the price of future production for a specific period of time. All risk management contracts are denominated in Canadian dollars. For the year ended December 31, 2010, the Company recorded a realized commodity contract gain of \$1,788,624 (2009 - \$166,107) and an unrealized commodity price contract loss of \$1,423,891 (2009 – gain of \$3,378). As at December 31, 2010 the Company has recorded a current future income tax asset in the amount of \$288,069 as a result of the current unrealized loss of \$993,344.

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

	As at December 31, 2010	As at December 31, 2009
Total fair value consists of the following:		
Current portion	\$ (993,344)	\$ 126,749
Long-term portion	\$ (427,169)	\$ (123,371)
Total fair value, end of year	\$ (1,420,513)	\$ 3,378

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

	2010	2009
Fair value, beginning of year	\$ 3,378	\$ 9,045,804
Changes in fair value	364,733	169,486
Settlement paid (received)	(1,788,624)	(9,211,912)
Fair value, end of year	\$ (1,420,513)	\$ 3,378

The Company had the following risk management contract outstanding as at December 31, 2010.

Commodity Sold	Volume Sold	Term	Pricing	Fair Value
Oil	100 bbl per day	Jan 1, 2010 - Apr 30, 2011	\$79.50 per bbl	\$ (153,373)
Oil	100 bbl per day	Jan 1, 2011 - Dec 31, 2011	\$85.50 per bbl	(298,584)
Oil	100 bbl per day	Jan 1, 2011 - Dec 31, 2011	\$89.50 per bbl	(153,844)
Oil	100 bbl per day	May 1, 2011 - Dec 31, 2012	\$87.05 per bbl	(457,085)
Oil	100 bbl per day	Jan 1, 2011 - Dec 31, 2011	\$88.00 per bbl	(208,121)
Oil	100 bbl per day	Jan 1, 2012 - Dec 31, 2012	\$90.65 per bbl	(149,506)
				\$ (1,420,513)

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Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

14. Risk management and financial instruments (continued):

In January 2011, the Company entered into two additional crude oil commodity price contracts as follows:

Commodity Sold	Volume Sold	Term	Pricing
Oil	100 bbl per day	Feb 1, 2011 - Dec 31, 2011	93.30 per bbl
Oil	300 bbl per day	Jan 1, 2012 - Dec 31, 2012	95.15 per bbl

Commodity price sensitivity:

Commodity Price	2010	2009
Natural gas production sold under fixed commodity contract (GJ)	-	455,000
Price Change (per GJ)	\$ 0.10	\$ 0.10
Sensitivity – loss before income tax	\$ -	\$ 45,500

Commodity Price	2010	2009
Oil production sold under fixed commodity contract (barrels)	219,200	231,000
Price Change (per bbl)	\$ 1.00	\$ 1.00
Sensitivity – loss before income tax	\$ 219,200	\$ 231,000

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.

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Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

14. Risk management and financial instruments (continued):

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 December 31, 2010 the Company's receivables consisted of \$2,036,210 (2009 - \$2,636,881) from joint interest partners the majority of which has either been collected or is expected to be collected within the next 60 days, \$5,556,153 (2009 - \$2,922,179) of receivables from petroleum and natural gas marketers, which have been collected and \$507,539 (2009 - \$910,985) of other receivables. At December 31, 2010, Arsenal had approximately \$831,856 (2009 - \$948,160) of receivables that are considered past due and collection efforts, including the taking of production and consideration of legal action have commenced.

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

The carrying amount of cash and cash equivalents and accounts receivable represents the maximum credit exposure. The Company did not have an allowance for doubtful accounts as at December 31, 2010 (December 31, 2009 - nil).

As at December 31, 2010 the Company considers its receivables to be aged as follows:

Aging	December 31, 2010
Not past due	\$ 7,268,046
Past due by more than 90 days	831,856
Total	\$ 8,099,902

d) Foreign currency exchange risk:

The Company is exposed to foreign currency fluctuations as crude oil and natural gas prices received are referenced to U.S. dollar denominated prices, and revenues earned and costs incurred in the U.S. are denominated in U.S. dollars. The Company has mitigated a portion of this exchange risk by entering into fixed Canadian dollar crude oil price swaps as outlined in note 14(a) and by denominating a portion of its debt in US dollars. At December 31, 2010, the Company had drawn U.S. \$6,875,000 (CAD - \$6,837,875) on its demand revolving operating loan. A \$0.01 increase or decrease in the Canadian / United States foreign

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Notes to Consolidated Financial Statements (Continued)
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14. Risk management and financial instruments (continued):

exchange rate would increase or decrease, as the case may be, loss before income taxes by approximately \$68,379.

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 \$16,064,700 average bank debt outstanding over the year ending December 31, 2010, a 100 basis point (1%) change in the interest rate would increase or decrease interest expense for the year by \$160,647.

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, 2010, the Company had a \$40 million credit facility (see note 8).

15. 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 and what, if any, additional initiatives may need to be implemented.

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

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Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

15. Capital management (continued):

such as drilling results and production profiles. The Company's board of directors approves the budget and reviews changes thereto. The Company has targeted a debt to equity ratio of 0.5 : 1. This ratio will also fluctuate over time depending on the state of equity markets and the results of operations.

At December 31, 2010, the Company's debt to annualized funds flow ratio was 0.92 : 1 and its debt to equity ratio was 0.28 : 1. Equity issues generating net proceeds of \$18.1 million in February and October 2010 reduced debt thereby improving the debt to annualized funds flow ratio and the debt to equity ratio. The debt to forward funds from operations ratio at December 31, 2010 is within the target range of the corporate goal of 1 : 1 as established in the management strategy goals and guidelines.

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, 2010, 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 doing so in the foreseeable future.

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

	December 31, 2010
Bank loan	\$ 11,412,875
Working capital deficiency (excluding risk management contracts and future income taxes)	7,374,900
Total debt	\$ 18,787,775
Annualized funds flow	\$ 20,476,996
Net debt to annualized funds flow ratio	0.92

16. Supplemental cash flow information:

	2010	2009
Change in non-cash working capital items:		
Accounts receivable	\$ (1,629,857)	\$ 1,091,153
Prepaid expenses and deposits	134,799	(23,996)
Accounts payable and accrued liabilities	2,542,631	(5,237,951)
	1,047,573	4,170,794
Amounts relating to operating activities	(4,042,961)	(45,587)
Amounts relating to financing activities	56,839	(60,270)
Amounts relating to investing activities	5,033,695	4,276,651
	1,047,573	4,170,794
Interest and taxes paid:		
Taxes paid	\$ 32,098	\$ -
Interest paid	\$ 710,461	\$ 1,327,184

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Notes to Consolidated Financial Statements (Continued)
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17. Segmented information:

A portion of the Company's assets and revenues are earned in the United States 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.

2010 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	28,143,213	15,522,507	43,665,720
Income (loss) before income taxes	(16,603,131)	3,974,187	(12,628,944)
Operating income ¹	12,606,086	8,371,572	20,977,658
Property, plant and equipment (note 5)	85,835,326	17,394,013	103,229,339
Acquisition of property	75,480	2,184,049	2,259,529
Property dispositions	(5,919,077)	-	(5,919,077)
Capital expenditures	20,326,174	7,716,137	28,042,311

2009 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	27,396,386	9,545,476	36,941,862
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

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

18. Commitments and contingencies:

a) Flow-through shares:

In connection with the issuance of flow-through common shares in 2010, the Company incurred a commitment to incur \$10,008,000 of eligible expenditures by December 31, 2011. As at December 31, 2010, the Company had approximately \$5,700,000 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	
2011	\$ 543,268
2012	337,121
2013	40,430
Total commitment	\$ 920,819

In order to ensure rig availability for the Company's operated wells in the state of North Dakota, the Company has committed to the utilization of a rig for a period of 200 days. As the Company will charge

ARSENAL ENERGY INC.

Notes to Consolidated Financial Statements (Continued)
Years ended December 31, 2010 and 2009

18. Commitments and contingencies (continued):

partners their proportionate share, the Company has estimated its commitment, based on drilling day rates and rig mobilization costs to be approximately \$3,000,000.

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.

19. Subsequent event:

On February 15, 2011, the Company issued 22,158,500 common shares at \$0.95 per share for gross proceeds of \$21,050,575 for which officers and directors of the Company subscribed for 174,750 share for gross proceeds of \$166,013.