



Unaudited Interim Consolidated Financial Statements of

ARSENAL ENERGY INC.

For the Three and Six Months ended June 30, 2010 and 2009

ARSENAL ENERGY INC.

Interim Consolidated Balance Sheets
(unaudited)

As at	June 30, 2010	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 602,111	\$ 1,325,915
Accounts receivable	7,170,156	6,470,045
Prepaid expenses and deposits	873,533	532,808
Risk management contracts (note 8(a))	1,067,527	126,749
	9,713,327	8,455,517
Reclamation deposit	159,690	157,650
Risk management contracts (note 8(a))	127,699	-
Property, plant and equipment (note 2)	105,024,874	108,267,249
	\$115,025,590	\$116,880,416
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 8,709,086	\$ 14,778,189
Bank loan (note 3)	19,823,000	22,290,000
Future income tax	309,583	36,757
	28,841,669	37,104,946
Risk management contracts (note 8)	-	123,371
Asset retirement obligations (note 5)	13,871,993	14,044,639
Future income taxes (note 8(a))	7,783,779	7,860,589
	50,497,441	59,133,545
Shareholders' Equity:		
Common shares (note 7(b))	111,078,587	100,955,986
Contributed surplus (note 7(g))	6,254,780	5,980,601
Accumulated other comprehensive loss	(509,880)	(507,506)
Deficit	(52,295,338)	(48,682,210)
	64,528,149	57,746,871
	\$ 115,025,590	\$ 116,880,416

Segmented information (note 11)
Commitments and contingencies (note 12)
Subsequent event (note 13)

See accompanying notes to interim consolidated financial statements.

ARSENAL ENERGY INC.

Interim Consolidated Statements of Operations and Deficit
(unaudited)

	Three Months Ended June 30		Six Months Ended June 30	
	2010	2009	2010	2009
Revenue				
Oil and gas	\$ 11,128,046	\$ 9,638,098	\$ 22,714,559	\$ 17,608,011
Realized gain (loss) on risk management contracts (note 8)	557,002	(4,147)	875,360	35,194
Unrealized gain (loss) on risk management contracts (note 8)	839,724	(714,457)	1,191,848	(458,611)
Royalties	(2,121,910)	(1,790,227)	(3,825,120)	(3,589,625)
	10,402,862	7,129,267	20,956,647	13,594,969
Other income	739	2,377	4,548	3,197
	10,403,601	7,131,644	20,961,195	13,598,166
Expenses				
Operating	3,912,841	3,383,363	7,601,237	7,038,927
Transportation	162,992	222,134	401,744	433,508
General and administrative	1,035,679	1,072,217	1,839,821	2,025,983
Finance charges and fees	357,052	546,665	615,707	783,964
Other expenses	-	590,000	-	590,000
Interest on convertible debentures	-	-	-	34,323
Foreign exchange (gain) loss	93,986	(900,359)	(76,340)	(1,104,428)
Convertible debenture accretion	-	-	-	16,911
Depletion, depreciation and accretion	6,899,560	6,741,852	14,762,562	13,325,100
Stock-based compensation (note 7(e))	162,854	273,634	279,273	538,559
	12,624,964	11,929,506	25,424,004	23,682,847
Loss before income taxes	(2,221,363)	(4,797,862)	(4,462,809)	(10,084,681)
Income taxes:				
Future income tax reduction	(368,251)	(1,562,202)	(849,681)	(3,777,310)
	(368,251)	(1,562,202)	(849,681)	(3,777,310)
Net loss for the period	(1,853,112)	(3,235,660)	(3,613,128)	(6,307,371)
Deficit, beginning of period	(50,442,226)	(40,703,405)	(48,682,210)	(37,631,694)
Deficit, end of period	\$ (52,295,338)	\$ (43,939,065)	\$ (52,295,338)	\$ (43,939,065)
Loss per share, basic and diluted (note 7(c))	\$ (0.01)	\$ (0.03)	\$ (0.03)	\$ (0.06)

Interim Consolidated Statement of Comprehensive Loss
(unaudited)

	Three Months Ended June 30		Six Months Ended June 30	
	2010	2009	2010	2009
Net loss for the period	\$ (1,853,112)	\$ (3,235,660)	\$ (3,613,128)	\$ (6,307,371)
Translation gain (loss) on foreign operations	150,626	(348,948)	(2,374)	(348,948)
Comprehensive loss	\$ (1,702,486)	\$ (3,584,608)	\$ (3,615,502)	\$ (6,656,319)

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	
	2010	2009	2010	2009
Cash provided by (used in):				
Operations:				
Net loss for the period	\$ (1,853,112)	\$ (3,235,660)	\$ (3,613,128)	\$ (6,307,371)
Items not affecting cash:				
Unrealized (gain) loss on risk management contracts	(839,711)	718,604	(1,191,848)	423,417
Depletion, depreciation and accretion	6,899,560	6,741,852	14,762,562	13,325,100
Future income tax reduction	(368,251)	(1,562,202)	(849,681)	(3,777,310)
Convertible debenture accretion	-	-	-	16,911
Stock-based compensation	162,854	273,634	279,273	538,559
Unrealized foreign exchange (gain) loss	119,955	(900,359)	12,874	(953,311)
Settlement of risk management contracts (note 8(a))	-	(4,147)	-	9,080,997
Asset retirement obligations settled	(394,940)	(101,322)	(628,552)	(354,464)
	3,726,355	1,930,400	8,771,500	11,992,528
Net change in non-cash working capital (note 10)	(5,756,690)	2,066,235	(5,377,125)	(1,017,908)
	(2,030,335)	3,996,635	3,394,375	10,974,620
Financing:				
Bank loan (repayments)	(5,292,700)	(5,972,532)	(5,292,700)	(7,372,004)
Bank loan advance	10,596,900	-	2,720,000	-
Repayment of convertible debentures	-	-	-	(3,480,000)
Issue of shares for cash	34,030	-	12,638,200	-
Repurchase of shares (note 7(f))	(542,707)	-	(542,707)	-
Share issue expenses	-	-	(1,033,909)	-
Net change in non-cash working capital items (note 10)	(27,905)	(59,966)	(1,888)	(112,604)
	4,767,618	(6,032,498)	8,486,996	(10,964,608)
Investing:				
Additions to property, plant and equipment	(2,405,406)	(1,139,845)	(11,039,356)	(3,714,906)
Disposition of property, plant and equipment	-	2,326,749	214,831	3,166,124
Net change in non-cash working capital items (note 10)	(2,127,956)	1,383,933	(1,730,926)	800,621
	(4,533,362)	2,570,837	(12,555,451)	251,836
Foreign exchange loss on cash held in foreign currency	(13,585)	(76,908)	(49,724)	(52,238)
Change in cash and cash equivalents during the period	(1,809,664)	458,066	(723,804)	209,613
Cash and cash equivalents, beginning of period	2,411,775	576,770	1,325,915	825,223
Cash and cash equivalents, end of period	\$ 602,111	\$ 1,034,836	\$ 602,111	\$ 1,034,836

Supplemental information (note 10)

See accompanying notes to interim consolidated financial statements

ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements

(Unaudited)

Three and Six Months ended June 30, 2010 and 2009

1. Significant accounting policies:

These interim 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, 2009. 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 for the year ended December 31, 2009. These interim consolidated financial statements include the accounts of Arsenal and its wholly owned subsidiaries.

2. Property, plant and equipment:

	June 30, 2010	December 31, 2009
Petroleum and natural gas properties	\$ 168,049,188	\$ 159,328,416
Production equipment	32,278,583	30,002,163
	200,327,771	189,330,579
Office furniture, equipment and other	495,146	443,343
	200,822,917	189,773,922
Accumulated depletion and depreciation	(95,798,043)	(81,506,673)
	\$ 105,024,874	\$ 108,267,249

In Canada and the United States, 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 \$3,922,191 (2009 - \$nil). Future development costs totaling \$2,552,700 (December 31, 2009 - \$2,552,700) in Canada and \$26,271,119 (December 31, 2009 - \$27,546,395) in the United States were included in the depletion calculation.

For the six months ended June 30, 2010, Arsenal capitalized direct general and administrative expenses of \$210,000 (2009 - \$175,800) and \$44,097 (2009 - \$113,308) of stock based compensation and \$15,655 (2009 - \$33,233) of future tax related thereto.

During the six months ending June 30, 2010, the Company disposed of a non-core minor property for proceeds of \$214,831. In addition, the Company disposed of asset retirement obligations relating to the property sold of \$210,282.

3. Bank loan:

At June 30, 2010, the Company had a \$40,000,000 credit facility consisting of a demand revolving operating loan facility of which \$19,823,000 had been drawn. The facility can be utilized in either Canadian or U.S. dollars.

At December 31, 2009, the Company had a non-revolving reducing term loan facility in the amount of \$4.08 million requiring reductions of \$820,000 per month. On January 29, 2010, the Company repaid its non-revolving reducing term loan.

Total debt which, includes bank debt and working capital deficiency but excludes the risk management contracts and future income tax, amounted to \$19,886,286 at June 30, 2010 (December 31, 2009 - \$28,739,421). Included in debt under the facility at June 30, 2010, is a U.S. \$5,000,000 (CAD - \$5,323,000) Libor based loan.

The credit facility at June 30, 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

3. Bank loan (continued):

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, 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.

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

Pursuant to the loan agreement, the Company cannot permit:

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

The Company is in compliance with its bank covenants at June 30, 2010.

In April, based on the bank's review of the Company's December 31, 2009 engineering report, the Company's credit facility was increased from \$31,00,0000 to \$40,000,000. The amount of the facility is subject to a borrowing base test performed annually on May 31st, primarily based on reserves, using commodity prices estimated by the lender, as well as other factors. During the first six months of 2010, the Company incurred interest on its credit facilities in the amount of \$425,048 (2009 - \$489,126).

4. 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 2010, the Company recorded a total of \$132,812 (June 30, 2009 - \$44,783) for legal fees and disbursements. As at June 30, 2010 accounts payable and accrued liabilities were \$nil (December 31, 2009 - \$42,232) relating to these payments.

All related party transactions have been recorded at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

5. 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:

	Six months ended June 30, 2010	Year ended December 31, 2009
Asset retirement obligations, beginning of period	\$ 14,044,639	\$ 14,498,062
Liabilities settled	(628,552)	(558,798)
Liabilities acquired	-	208,769
Liabilities disposed	(210,282)	(2,541,950)
Liabilities incurred	72,207	134,476
Change in estimate	-	1,619,119
Foreign currency translation	36,611	(343,818)
Accretion expense	557,370	1,028,779
Asset retirement obligations, end of period	\$ 13,871,993	\$ 14,044,639

5. Asset retirement obligations (continued):

The total undiscounted amount of estimated cash flows required to settle the obligation is \$35.6 million (June 30, 2009 - \$37.1 million), 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 2017 and 2022; however approximately \$5.4 million in obligations are not anticipated to be incurred until after 2030.

6. Convertible debentures:

Arsenal completed a corporate acquisition on March 14, 2006, and assumed obligations under 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.

7. 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, 2010		Year Ended December 31, 2009	
	Number	Amount	Number	Amount
Common shares:				
Balance, beginning of period	120,461,890	\$ 100,955,986	101,249,646	\$ 93,515,925
Issued on exercise of options	96,500	47,650	-	-
Common shares issued	11,283,000	9,590,550	8,000,000	4,000,000
Flow-through common shares issued	3,000,000	3,000,000	11,250,000	5,000,000
Tax effect of flow-through shares	-	(1,250,000)	-	(1,040,000)
Share issue costs	-	(1,033,910)	-	(665,580)
Tax effect of share issue costs	-	261,827	-	180,125
Unclaimed shares returned to treasury	-	-	(37,756)	(34,484)
Allocated from contributed surplus	-	40,666	-	-
Normal course issuer bid	(645,918)	(534,182)	-	-
Balance, end of period	134,195,472	\$ 111,078,587	120,461,890	\$ 100,955,986

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.

7. Shareholder's equity (continued):

Flow-through shares:

As part of the common share issuance 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 June 30, 2010, no 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 June 30, 2010, approximately \$800,000 has been incurred on exploration expenditures requiring approximately \$700,000 to be incurred by December 31, 2010.

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 require the Company incur Canadian Exploration Expenses in the amount of \$3,500,000 by December 31, 2010. As at June 30, 2010, all expenditures had been incurred.

c) Per share amounts:

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

	Three Months Ended June 30,		Six Months Ended June 30	
	2010	2009	2010	2009
Basic and diluted:				
Loss per share basic and diluted	\$(0.01)	\$(0.03)	\$(0.03)	\$(0.06)
Shares outstanding:				
Basic	134,766,268	101,249,646	130,342,257	101,249,646
Diluted	134,766,268	101,249,646	130,342,257	101,249,646

In calculating the per share amounts for the six months ended June 30, 2010, 12,804,500 (2009 – 8,399,000) options were excluded from the dilution calculation, as they were anti-dilutive.

d) 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.

7. Shareholder's equity (continued):

The following table summarizes the status of the Company's stock option plan as at June 30, 2010 and December 31, 2009 and the changes during those periods:

	Six Months Ended June 30, 2010		Year Ended December 31, 2009	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Balance, beginning of period	9,322,000	\$ 0.55	7,361,000	\$ 0.70
Granted	4,140,000	0.88	3,133,000	0.31
Exercised	(96,500)	0.49	-	-
Expirations	(525,000)	1.21	(150,000)	0.59
Forfeited	(36,000)	0.37	(1,022,000)	0.94
Balance, end of period	12,804,500	\$ 0.63	9,322,000	\$ 0.55
Exercisable, end of period	5,020,832	\$ 0.62	4,991,999	\$ 0.73

The following table summarizes information about the stock options outstanding and exercisable at June 30, 2010:

Range	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	3.51	548,666	\$ 0.21
\$0.36 to \$0.50	3,755,500	0.40	3.48	1,221,166	0.39
\$0.51 to \$0.70	1,446,000	0.60	2.65	1,446,000	0.60
\$0.71 to \$1.00	5,290,000	0.86	4.46	1,150,000	0.79
\$1.01 to \$1.50	655,000	1.15	0.93	655,000	1.15
Total	12,804,500	\$ 0.63	3.67	5,020,832	\$ 0.62

e) Stock-based compensation:

Options granted to employees are accounted for using the fair value method. The fair value of stock options granted during the first six months of 2010 was \$2,509,293 (\$0.61 per option) (2009 - \$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 grants as follows:

Six Months Ended June 30,	2010	2009
Risk free rate	2.58 - 2.90%	1.46%
Expected life	5 years	5 years
Expected volatility	87%	152%
Expected dividend	nil	nil
Expected forfeitures	nil	nil

7. Shareholder's equity (continued):

f) 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 June 30, 2010, the Company had acquired 645,918 common shares under the bid at an average at a cost of \$542,707. The cost of these shares exceeded their stated amount by \$8,525 (see note 7(g)) and has been recorded to contributed surplus.

g) Contributed surplus:

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

	Six Months Ended June 30, 2010	Year Ended December 31, 2009
Balance, beginning of period:	\$ 5,980,601	\$ 4,451,743
Stock-based compensation expensed	279,273	912,571
Stock-based compensation capitalized	44,097	211,803
Transferred to share capital	(40,666)	-
Normal course issuer bid	(8,525)	-
Reclassification of equity component of debenture (note 6)	-	370,000
Unclaimed shares returned to treasury	-	34,484
Balance, end of period	\$ 6,254,780	\$ 5,980,601

8. 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 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.

As at June 30, 2010, the Company has six crude oil swaps and one natural gas swap in-place fixing the price of future production. All risk management contracts are denominated in Canadian dollars. For the six months ended June 30, 2010, the Company recorded a realized commodity contract gain of \$875,360 (2009 - \$35,194) and an unrealized commodity contract gain of \$1,191,848 (2009 - loss of \$458,611). As at June 30, 2010 the Company has recorded a current future income tax liability in the amount of \$309,583 based on the current unrealized gain of \$1,067,527.

8. Risk management and financial instruments (continued):

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

	As at June 30, 2010	As at December 31, 2009
Total fair value consists of the following:		
Fair value, end of period - current portion	\$ 1,067,527	\$ 126,749
Fair value, end of period - long-term portion	127,699	(123,371)
Total fair value, end of period	\$ 1,195,226	\$ 3,378

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

	Three Months Ended June 30		Six Months Ended June 30	
	2010	2009	2010	2009
Fair value, beginning of period	\$ 355,515	\$ 255,847	\$ 3,378	\$ 9,045,804
Changes in fair value	1,396,713	(718,604)	2,067,208	(423,417)
Settlement paid (received)	(557,002)	4,147	(875,360)	(9,080,997)
Fair value, end of period	\$ 1,195,226	\$ (458,610)	\$ 1,195,226	\$ (458,610)

The Company had the following risk management contract outstanding as at June 30, 2010.

Commodity	Volume	Remaining	Pricin	Fair
Natural	1,000 GJ per	July 1, 2010 - Dec 31,	\$6.78 per	\$497,98
Oi	100 bbl per day	July 1, 2010 - Apr 30,	\$79.50 per	(77,635
Oi	200 bbl per day	July 1, 2010 - Dec 31,	\$85.05 per	
Oi	300 bbl per day	July 1, 2010 - Dec 31,	\$87.70 per	
Oi	100 bbl per day	Jan 1, 2011 - Dec 31,	\$85.50 per	
Oi	100 bbl per day	Jan 1, 2011 - Dec 31,	\$89.50 per	
Oi	100 bbl per day	May 1, 2011 - Dec 31,	\$87.05 per	
				\$1,195,22

Commodity price sensitivity:

Commodity	201
Natural gas production sold under fixed commodity contract	184,00
Price Change (per	\$ 0.1
Sensitivity - loss before income	\$ 18,40

Commodity	
Oil production sold under fixed commodity contract	256,50
Price Change (per	\$ 1.0
Sensitivity - loss before income	\$ 256,50

8. Risk management and financial instruments (continued):

b) Fair value of financial instruments:

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

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

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

c) Credit risk:

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

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

As at June 30, 2010 the Company's receivables consisted of \$3,416,227 (December 31, 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, \$3,166,942 (December 31, 2009 - \$2,922,179) of receivables from petroleum and natural gas marketers, which have been collected and \$586,987 (December 31, 2009 - \$910,986) of other receivables. At June 30, 2010, Arsenal had approximately \$599,870 (December 31, 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

8. Risk management and financial instruments (continued):

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 June 30, 2010 (December 31, 2009 - nil).

As at June 30, 2010 the Company considers its receivables to be aged as follows:

Aging	June 30, 2010
Not past due	\$ 6,570,286
Past due by more than 90 days	599,870
Total	\$ 7,170,156

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, 2010, the Company had outstanding U.S. \$5,000,000 (CAD - \$5,323,000) 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, loss before income taxes by approximately \$50,000.

e) Interest rate risk:

The Company is exposed to interest rate risk to the extent that the revolving demand loan is at a floating rate of interest. Based on \$18.9 million average bank loan outstanding over the six months ending June

30, 2010, a 100 basis point (1%) change in the interest rate would increase or decrease loss before income taxes for the six month period by \$93,738.

All debt is denominated in Canadian dollars, except for U.S. \$5,000,000 (CAD - \$5,323,000) of Libor based loans.

f) Liquidity risk:

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as much as possible, that it will always have sufficient liquidity to meet its liabilities when due, under normal and stressed conditions. Management closely monitors cash flow requirements to ensure that it has sufficient cash on demand or borrowing capacity to meet operational and financial obligation. At June 30, 2010, the Company had a \$40.0 million credit facility (see note 3).

9. Capital management:

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

The Company considers shareholders equity, bank loan and working capital as components of its capital base. 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 loan, 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 the target range. The Company prepares an annual operating and capital expenditure budget. The budget is updated when critical factors change and actual results are realized. Critical factors include economic factors such as the state of equity markets, changes to commodity prices, interest rates and foreign exchange rates and non economic factors such as drilling results and production profiles. The Company's board of directors approves the budget and reviews changes thereto. 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 June 30, 2010, the Company's debt to annualized funds flow ratio was 1.21 : 1 and its debt to equity ratio was 0.31 : 1. An equity issue generating net proceeds of approximately \$11.6 million in February 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 June 30, 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 June 30, 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 foresee doing so in the foreseeable future.

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

9. Capital management (continued):

	June 30, 2010	
Bank loan	\$	19,823,000
Working capital (excluding risk management contracts and future income taxes)		63,286
Total debt	\$	19,886,286
Annualized funds flow	\$	16,485,180
Net debt to annualized funds flow ratio		1.21

10. Supplemental cash flow information:

Six Months ended June 30	2010	2009
Change in non-cash working capital items:		
Accounts receivable	\$ (700,111)	\$ (1,054,816)
Prepaid expenses and deposits	(340,724)	(235,322)
Accounts payable and accrued liabilities	(6,069,104)	960,2247
	(7,109,939)	(329,891)
Amounts relating to operating activities	(5,377,125)	(1,017,908)
Amounts relating to financing activities	(1,888)	800,621
Amounts relating to investing activities	(1,730,926)	(112,604)
	\$ (7,109,939)	\$ (329,891)
Interest paid	\$ 450,657	\$ 197,314

11. Segmented information:

A portion of the Company's assets and revenues are earned in the United States and Canada, and are monitored as an identifiable reporting segment by management. Business risks and economic indicators are similar across all geographical regions.

June 30, 2010 (\$Cdn.)	Canada	U.S.	Total
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Oil and gas revenue	15,448,102	7,266,457	22,714,559
Income (loss) after taxes	(5,004,945)	1,391,817	(3,613,128)
Operating income ¹	6,989,766	3,896,692	10,886,458
Property, plant and equipment	92,321,376	12,703,498	105,024,874
Property dispositions	(214,831)	-	(214,831)
Capital expenditures	8,041,612	2,997,744	11,039,356

June 30, 2009 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	13,869,115	3,738,896	17,608,011
Income (loss) after taxes	(7,526,968)	1,219,597	(6,307,371)
Operating income ¹	5,481,861	1,064,090	6,545,951
Property, plant and equipment ²	97,686,924	10,580,325	108,267,249
Property dispositions	(3,166,124)	-	(3,166,124)
Capital expenditures	1,649,688	2,065,218	3,714,906

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

² As at December 31, 2009

12. Commitments and contingencies:

a) Flow-through shares:

In connection with the issuance of flow-through common shares in 2010 and 2009, as of June 30, 2010 the Company has a commitment to incur \$700,000 of eligible expenditures by December 31, 2010 and a further \$3,000,000 of eligible expenditures by December 31, 2011.

b) Office premises and equipment leases:

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

Office premises and equipment leases	
2010	\$ 256,051
2011	494,752
2012	288,605
2013	-
Total commitment	\$ 1,039,408

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 operations. Should any loss result from the resolution of these claims, such loss will be charged to operations in the year of resolution.

13. Subsequent events:

- On August 9, 2010, the Company sold its noncore North East British Columbia natural gas property for gross proceeds of \$2.7 million. Production from the property was less than 100 Boe per day.
- On August 10, 2010, the Company entered in two crude oil commodity price contracts, to sell 100 barrels of production per day from January 1, 2011 until December 31, 2011 at a price of \$88.00 Canadian per barrel and to sell 100 barrels of production per day from January 1, 2012 until December 31, 2012 at a price of \$90.65 Canadian per barrel.