

Unaudited Interim Consolidated Financial Statements of

**ARSENAL ENERGY INC.**

For the Three and Nine Months ended September 30, 2010 and 2009

# ARSENAL ENERGY INC.

Interim Consolidated Balance Sheets  
(unaudited)

As at	September 30, 2010	December 31, 2009
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 959,250	\$ 1,325,915
Accounts receivable	8,215,198	6,470,045
Prepaid expenses and deposits	485,034	532,808
Risk management contracts (note 8(a))	325,892	126,749
	9,985,374	8,455,517
Reclamation deposit	154,350	157,650
Property, plant and equipment (note 2)	94,312,946	108,267,249
	\$ 104,452,670	\$ 116,880,416
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 11,350,534	\$ 14,778,189
Bank loan (note 3)	13,370,000	22,290,000
Future income tax	94,508	36,757
	24,815,042	37,104,946
Risk management contracts (note 8(a))	246,911	123,371
Asset retirement obligations (note 5)	12,044,590	14,044,639
Future income taxes	6,791,963	7,860,589
	43,898,506	59,133,545
Shareholders' Equity:		
Common shares (note 7(b))	110,695,561	100,955,986
Contributed surplus (note 7(g))	6,605,203	5,980,601
Accumulated other comprehensive loss	(622,992)	(507,506)
Deficit	(56,123,608)	(48,682,210)
	60,554,164	57,746,871
	\$ 104,452,670	\$ 116,880,416

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

See accompanying notes to interim consolidated financial statements.

# ARSENAL ENERGY INC.

Interim Consolidated Statements of Operations and Deficit  
(unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2010	2009	2010	2009
<b>Revenue</b>				
Oil and gas	\$ 9,701,018	\$ 8,975,159	\$ 32,415,577	\$ 26,182,346
Realized gain on risk management contracts (note 8)	646,141	109,124	1,521,501	144,317
Unrealized gain (loss) on risk management contracts (note 8)	(1,116,245)	1,292,917	75,603	834,307
Royalties	(2,049,744)	(1,431,761)	(5,874,864)	(4,620,562)
	7,181,170	8,945,439	28,137,817	22,540,408
Other income	14,468	27,755	19,016	30,952
	7,195,638	8,973,194	28,156,833	22,571,360
<b>Expenses</b>				
Operating	3,110,135	3,212,794	10,711,372	10,251,721
Transportation	192,385	199,899	594,129	633,407
General and administrative	982,598	928,609	2,822,419	2,954,592
Finance charges and fees	242,071	423,564	857,778	1,207,528
Other expenses	-	10,000	-	600,000
Interest on convertible debentures	-	-	-	34,323
Foreign exchange (gain) loss	30,498	(605,132)	(45,842)	(1,709,560)
Convertible debenture accretion	-	-	-	16,911
Depletion, depreciation and accretion	7,359,524	5,909,734	22,122,086	19,234,834
Stock-based compensation (note 7(e))	274,254	211,488	553,527	750,047
	12,191,465	10,290,956	37,615,469	33,973,803
Loss before income taxes	(4,995,827)	(1,317,762)	(9,458,636)	(11,402,443)
Current income tax reduction (expense)	-	(277,621)	-	(277,621)
Future income tax reduction (expense)	1,167,557	(302,378)	2,017,238	3,474,932
	1,167,557	(579,999)	2,017,238	(3,197,311)
Net loss for the period	(3,828,270)	(1,897,761)	(7,441,398)	(8,205,132)
Deficit, beginning of period	(52,295,338)	(43,939,065)	(48,682,210)	(37,631,694)
Deficit, end of period	\$ (56,123,608)	\$ (45,836,826)	\$ (56,123,608)	\$ (45,836,826)
Loss per share, basic and diluted (note 7(c))	\$ (0.03)	\$ (0.02)	\$ (0.06)	\$ (0.08)

Interim Consolidated Statement of Comprehensive Loss  
(unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2010	2009	2010	2009
Net loss for the period	\$ (3,828,270)	\$ (1,897,761)	\$ (7,441,398)	\$ (8,205,132)
Translation loss on foreign operations	(113,112)	(392,306)	(115,486)	(741,254)
Comprehensive loss	\$ (3,941,382)	\$ (2,290,067)	\$ (7,556,884)	\$ (8,946,386)

See accompanying notes to interim consolidated financial statements.

# ARSENAL ENERGY INC.

Interim Consolidated Statements of Cash Flows  
(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2010	2009	2010	2009
<b>Cash provided by (used in):</b>				
<b>Operations:</b>				
Net loss for the period	\$ (3,828,270)	\$ (1,897,761)	\$ (7,441,398)	\$ (8,205,132)
Items not affecting cash:				
Unrealized (gain) loss on risk management contracts	1,116,245	(1,402,041)	(75,603)	(978,624)
Depletion, depreciation and accretion	7,359,524	5,909,734	22,122,086	19,234,834
Future income tax reduction	(1,167,557)	302,378	(2,017,238)	(3,474,932)
Convertible debenture accretion	-	-	-	16,911
Stock-based compensation	274,254	211,488	553,527	750,047
Unrealized foreign exchange (gain) loss	22,126	(345,096)	35,000	(1,298,407)
Settlement of risk management contracts (note 8(a))	-	109,124	-	9,190,121
Asset retirement obligations settled	(365,112)	30,413	(993,664)	(324,051)
	3,411,210	2,918,239	12,182,710	14,910,767
Net change in non-cash working capital (note 10)	873,199	196,560	(4,503,926)	(821,348)
	4,284,409	3,114,799	7,678,784	14,089,419
<b>Financing:</b>				
Bank loan (repayments)	(9,500,000)	(5,308,000)	(10,872,700)	(12,680,004)
Bank loan advance	3,225,000	-	2,025,000	-
Repayment of convertible debentures	-	-	-	(3,480,000)
Issue of shares for cash	-	3,500,000	12,638,200	3,500,000
Repurchase of shares (note 7(f))	(359,646)	-	(902,353)	-
Share issue expenses	-	(247,890)	(1,033,910)	(247,890)
Net change in non-cash working capital items (note 10)	37,332	61,652	35,444	(50,952)
	(6,597,314)	(1,994,238)	1,889,681	(12,958,846)
<b>Investing:</b>				
Additions to property, plant and equipment	(4,089,218)	(3,264,967)	(15,128,574)	(6,979,873)
Disposition of property, plant and equipment	5,704,246	265,860	5,919,077	3,431,984
Net change in non-cash working capital items (note 10)	1,074,374	1,905,397	(656,552)	2,706,018
	2,689,402	(1,093,710)	(9,866,049)	(841,871)
Foreign exchange loss on cash held in foreign currency	(19,358)	(58,452)	(69,081)	(110,690)
Change in cash and cash equivalents during the period	357,139	(31,601)	(366,665)	178,012
Cash and cash equivalents, beginning of period	602,111	1,034,836	1,325,915	825,223
Cash and cash equivalents, end of period	\$ 959,250	\$ 1,003,235	\$ 959,250	\$ 1,003,235

Supplemental information (note 10)

See accompanying notes to interim consolidated financial statements

# ARSENAL ENERGY INC.

Notes to Interim Consolidated Financial Statements

(Unaudited)

Three and Nine Months ended September 30, 2010 and 2009

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## 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.

Certain comparative amounts have been reclassified to conform to current period presentation.

## 2. Property, plant and equipment:

	September 30, 2010	December 31, 2009
Petroleum and natural gas properties	\$ 164,433,615	\$ 159,328,416
Production equipment	32,108,332	30,002,163
	196,541,947	189,330,579
Office furniture, equipment and other	500,682	443,343
	197,042,629	189,773,922
Accumulated depletion and depreciation	(102,729,683)	(81,506,673)
	\$ 94,312,946	\$ 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 \$4,121,461 (2009 - \$nil) and \$628,266 (2009 - \$nil) in the United States. Future development costs totaling \$2,552,700 (December 31, 2009 - \$2,552,700) in Canada and \$24,439,508 (December 31, 2009 - \$27,546,395) in the United States were included in the depletion calculation.

For the nine months ended September 30, 2010, Arsenal capitalized direct general and administrative expenses of \$371,000 (2009 - \$263,700) and \$96,886 (2009 - \$164,158) of stock based compensation and \$34,396 (2009 - \$57,827) of future tax related thereto.

During the nine months ending September 30, 2010, the Company disposed of a non-core minor property for proceeds of \$5,919,077. In addition, the Company disposed of asset retirement obligations relating to the property sold of \$1,840,048.

## 3. Bank loan:

At September 30, 2010, the Company had a \$40,000,000 credit facility consisting of a demand revolving operating loan facility of which \$13,370,000 had been drawn. The facility can be utilized in either Canadian or U.S. dollars.

Total debt which, includes bank debt and working capital deficiency but excludes the risk management contracts and future income tax, amounted to \$15,061,052 at September 30, 2010 (December 31, 2009 - \$28,739,421). Included in debt under the facility at September 30, 2010, is a U.S. \$5,000,000 (CAD - \$5,145,000) Libor 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.

### 3. Bank loan (continued):

The credit facility at September 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 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 September 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 \$31,000,000 to \$40,000,000. 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 sole discretion of the lender. During the first nine months of 2010, the Company incurred interest on its credit facilities in the amount of \$610,294 (2009 - \$863,099).

### 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 nine months of 2010, the Company recorded a total of \$152,977 (September 30, 2009 - \$118,902) for legal fees and disbursements. As at September 30, 2010 accounts payable and accrued liabilities were \$nil (December 31, 2009 - \$42,720) 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:

	Nine months ended September 30, 2010	Year ended December 31, 2009
Asset retirement obligations, beginning of period	\$ 14,044,639	\$ 14,498,062
Liabilities settled	(993,664)	(558,798)
Liabilities acquired	13,264	208,769
Liabilities disposed (note2)	(1,840,048)	(2,541,950)
Liabilities incurred	71,972	134,476
Change in estimate	-	1,619,119
Foreign currency translation	(54,154)	(343,818)
Accretion expense	802,581	1,028,779
Asset retirement obligations, end of period	\$ 12,044,590	\$ 14,044,639

## 5. Asset retirement obligations (continued):

The total undiscounted amount of estimated cash flows required to settle the obligation is \$31.6 million (September 30, 2009 - \$27.6 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 \$5.3 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 September 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:

	Nine Months Ended September 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	(1,106,918)	(917,208)	-	-
Balance, end of period	133,734,472	\$ 110,695,561	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:

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 September 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 require the Company to incur Canadian Exploration Expenses in the amount of \$1,500,000 by December 31, 2010. As at September 30, 2010, approximately \$800,000 has been incurred 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 September 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 September 30		Nine Months Ended September 30	
	2010	2009	2010	2009
Basic and diluted:				
Loss per share basic and diluted	\$(0.03)	\$(0.02)	\$(0.06)	\$(0.08)
Shares outstanding:				
Basic	134,006,733	103,903,661	131,578,389	102,144,039
Diluted	134,006,733	103,903,661	131,578,389	102,144,039

In calculating the per share amounts for the nine months ended September 30, 2010, 12,929,500 (2009 – 8,127,000) 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 September 30, 2010 and December 31, 2009 and the changes during those periods:

	Nine Months Ended September 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	4,280,000	0.88	3,133,000	0.31
Exercised	(96,500)	0.49	-	-
Expirations	(540,000)	1.22	(150,000)	0.59
Forfeited	(36,000)	0.37	(1,022,000)	0.94
Balance, end of period	12,929,500	\$ 0.63	9,322,000	\$ 0.55
Exercisable, end of period	5,039,165	\$ 0.62	4,991,999	\$ 0.73

The following table summarizes information about the stock options outstanding and exercisable at September 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	3.26	548,666	\$ 0.21
\$0.36 to \$0.50	3,755,500	0.40	3.23	1,254,499	0.39
\$0.51 to \$0.70	1,446,000	0.60	2.40	1,446,000	0.60
\$0.71 to \$1.00	5,430,000	0.86	4.23	1,150,000	0.79
\$1.01 to \$1.30	640,000	1.14	0.69	640,000	1.15
Total	12,929,500	\$ 0.63	3.43	5,039,165	\$ 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 nine months of 2010 was \$2,586,615 (\$0.60 per option) (2009 - \$414,242 (\$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:

Nine Months Ended September 30,	2010	2009
Risk free rate	2.05 - 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 September 30, 2010, the Company had acquired 1,106,918 common shares under the bid at a cost of \$902,353. The stated value of these shares exceeded their cost by \$14,855 (see note 7(g)) and has been recorded to contributed surplus. (see note 13(c)).

### g) Contributed surplus:

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

	Nine Months Ended September 30, 2010	Year Ended December 31, 2009
Balance, beginning of period:	\$ 5,980,601	\$ 4,451,743
Stock-based compensation expensed	553,527	912,571
Stock-based compensation capitalized	96,886	211,803
Transferred to share capital	(40,666)	-
Normal course issuer bid	14,855	-
Reclassification of equity component of debenture (note 6)	-	370,000
Unclaimed shares returned to treasury	-	34,484
Balance, end of period	\$ 6,605,203	\$ 5,980,601

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.

## 8. Risk management and financial instruments:

### a) Risk management contract:

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 the 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 September 30, 2010, the Company has eight 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 nine months ended September 30, 2010, the Company recorded a realized commodity contract gain of \$1,521,501 (2009 - \$144,317) and an unrealized commodity contract gain of \$75,603 (2009 - \$834,307). As at September 30, 2010 the Company has recorded a current future income tax liability in the amount of \$94,508 based on the current unrealized gain of \$325,892.

## 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 September 30, 2010	As at December 31, 2009
Total fair value consists of the following:		
Fair value, end of period - current portion	\$ 325,892	\$ 126,749
Fair value, end of period - long-term portion	\$ (246,911)	\$ (123,371)
<b>Total fair value, end of period</b>	<b>\$ 78,981</b>	<b>\$ 3,378</b>

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

	Three Months Ended September 30		Nine Months Ended September 30	
	2010	2009	2010	2009
Fair value, beginning of period	\$ 1,195,226	\$ (458,610)	\$ 3,378	\$ 9,045,804
Changes in fair value	(470,104)	1,402,041	1,597,104	978,624
Settlement paid (received)	(646,141)	(109,124)	(1,521,501)	(9,190,121)
<b>Fair value, end of period</b>	<b>\$ 78,981</b>	<b>\$ 834,307</b>	<b>\$ 78,981</b>	<b>\$ 834,307</b>

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

Commodity Sold	Volume Sold	Term	Pricing	Fair Value
Natural Gas	1,000 GJ per day	Oct 1, 2010 - Dec 31, 2010	\$ 6.78 per GJ	\$ 302,244
Oil	100 bbl per day	Oct 1, 2010 - Apr 30, 2011	79.50 per bbl	(119,439)
Oil	200 bbl per day	Oct 1, 2010 - Dec 31, 2010	85.05 per bbl	25,301
Oil	300 bbl per day	Oct 1, 2010 - Dec 31, 2010	87.70 per bbl	110,881
Oil	100 bbl per day	Jan 1, 2011 - Dec 31, 2011	85.50 per bbl	(87,562)
Oil	100 bbl per day	Jan 1, 2011 - Dec 31, 2011	89.50 per bbl	56,741
Oil	100 bbl per day	May 1, 2011 - Dec 31, 2012	87.05 per bbl	(190,198)
Oil	100 bbl per day	Jan 1, 2011 - Dec 31, 2011	88.00 per bbl	2,628
Oil	100 bbl per day	Jan 1, 2012 - Dec 31, 2012	90.65 per bbl	(21,615)
				<b>78,981</b>

Commodity price sensitivity:

Commodity Price	2010
Natural gas production sold under fixed commodity contract (GJ)	92,000
Price Change (per GJ)	\$ 0.10
<b>Sensitivity - loss before income tax</b>	<b>\$ 9,200</b>

Commodity Price	
Oil production sold under fixed commodity contract (barrels)	274,400
Price Change (per bbl)	\$ 1.00
<b>Sensitivity - loss before income tax</b>	<b>\$ 274,400</b>

## 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 September 30, 2010 the Company's receivables consisted of \$4,091,827 (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, \$3,737,108 (December 31, 2009 - \$2,922,179) of receivables from petroleum and natural gas marketers, which have been collected and \$386,263 (December 31, 2009 - \$910,986) of other receivables. At September 30, 2010, Arsenal had approximately \$1,026,150 (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 25<sup>th</sup> day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint interest receivables are typically collected within one to three months of the joint interest bill being issued to the partner. The Company attempts to mitigate the risk from joint interest receivables by obtaining partner approval of significant capital expenditures and payment of cash advances prior to expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances are

## 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 September 30, 2010 (December 31, 2009 - nil).

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

Aging	September 30, 2010
Not past due	\$ 7,189,048
Past due by more than 90 days	1,026,150
Total	\$ 8,215,198

### d) Foreign currency exchange risk:

The Company is exposed to foreign currency fluctuations as crude oil and natural gas prices received are referenced to United States dollar denominated prices, and revenues earned and costs incurred in the United States are denominated in United States dollars. The Company has mitigated a portion of this exchange risk by entering into fixed Canadian dollar crude oil price swaps as outlined in the commodity price risk section above. At September 30, 2010, the Company had outstanding U.S. \$5,000,000 (CAD - \$5,145,000) 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 \$18.6 million average bank loan outstanding over the nine months ending September 30, 2010, a 100 basis point (1%) change in the interest rate would increase or decrease loss before income taxes for the nine month period by \$139,190.

All debt is denominated in Canadian dollars, except for U.S. \$5,000,000 (CAD - \$5,145,000) 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 September 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 September 30, 2010, the Company's debt to annualized funds flow ratio was 1.00 : 1 and its debt to equity ratio was 0.25 : 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 September 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 September 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):

	September 30, 2010	
Bank loan	\$	13,370,000
Working capital (excluding risk management contracts and future income taxes)		1,691,052
Total debt	\$	15,061,052
Annualized funds flow	\$	15,105,288
Net debt to annualized funds flow ratio		1.00

## 10. Supplemental cash flow information:

Nine Months ended September 30	2010	2009
Change in non-cash working capital items:		
Accounts receivable	\$ (1,745,153)	\$ 127,137
Prepaid expenses and deposits	47,774	(61,567)
Accounts payable and accrued liabilities	(3,427,655)	1,768,148
	(5,125,034)	1,833,718
Amounts relating to operating activities	(4,503,926)	(821,348)
Amounts relating to financing activities	35,444	(50,952)
Amounts relating to investing activities	(656,552)	2,706,018
	\$ (5,125,034)	\$ 1,833,718
Interest paid	\$ 640,387	\$ 803,678

## 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.

September 30, 2010 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	21,386,309	11,029,268	32,415,577
Income (loss) after taxes	(9,177,138)	1,735,740	(7,441,398)
Operating income <sup>1</sup>	9,461,266	5,773,946	15,235,212
Property, plant and equipment	80,577,049	13,735,897	94,312,946
Property dispositions	(5,919,077)	-	(5,919,077)
Capital expenditures	10,021,503	5,107,071	15,128,574
September 30, 2009 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	20,152,263	6,030,083	26,182,346
Income (loss) after taxes	(8,973,907)	768,775	(8,205,132)
Operating income <sup>1</sup>	8,242,765	2,433,891	10,676,656
Property, plant and equipment <sup>2</sup>	97,686,924	10,580,325	108,267,249
Property dispositions	(3,431,984)	-	(3,431,984)
Capital expenditures	2,258,758	4,721,115	6,979,873

<sup>1</sup> Defined as oil and gas revenues less royalties, operating costs and transportation.

<sup>2</sup> 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 September 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	\$ 133,509
2011	543,268
2012	337,121
2013	40,430
Total commitment	\$ 1,054,328

### 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:

- a) 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. 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.
- b) 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 partners their proportionate share, the Company has estimated its commitment, based on drilling day rates and rig mobilization costs, to be between \$1,800,000 and \$2,800,000.
- c) Subsequent to September 30, 2010, the Company acquired 265,500 common shares under the NCIB (note 7(f)) at a cost of \$226,302.