

Unaudited Condensed Interim Consolidated Financial Statements of

ARSENAL ENERGY INC.

For the Three and Nine Months Ended September 30, 2011 and 2010

Arsenal Energy Inc.

Condensed Interim Consolidated Statement of Financial Position
(Unaudited)

As at	September 30, 2011	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,552,364	\$ 1,448,009
Accounts receivable	9,397,598	8,099,902
Prepaid expenses and deposits	363,339	398,009
	11,313,301	9,945,920
Reclamation deposit	157,230	149,190
Exploration and evaluation assets (note 5)	6,413,055	6,394,505
Property, plant and equipment (note 6 and 7)	87,773,540	74,331,026
Deferred taxes	1,775,276	1,775,276
	\$107,432,402	\$92,595,917
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 16,637,621	\$ 17,320,820
Bank loan (note 8)	-	11,412,875
Risk management contracts (note 11(a))	-	993,344
	16,637,621	29,727,039
Bank loan (note 8)	3,915,690	-
Flow through share premium	102,035	792,968
Risk management contracts (note 11(a))	-	427,169
Decommissioning obligations (note 9)	21,865,988	19,667,331
Deferred taxes	4,584,260	1,473,676
	47,105,594	52,088,183
Shareholders' Equity:		
Common shares	139,108,104	122,609,238
Contributed surplus	8,929,743	7,374,054
Accumulated other comprehensive income (loss)	58,548	(199,996)
Deficit	(87,769,587)	(89,275,562)
	60,326,808	40,507,734
	\$107,432,402	\$ 92,595,917

Subsequent event (notes 11 and 17)

Segmented Information (note 15)

Commitments and contingencies (note 16)

The notes are an integral part of these condensed interim consolidated financial statements.

Arsenal Energy Inc.

Condensed Interim Consolidated Statements of Income (Loss) and Comprehensive Income (Loss)
(Unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2011	2010 (note 18)	2011	2010 (note 18)
Revenue				
Oil and gas	\$ 15,027,512	\$ 9,701,018	\$ 39,376,528	\$ 32,415,577
Royalties	(3,042,968)	(2,049,744)	(7,621,824)	(5,874,864)
	11,984,544	7,651,274	31,754,704	26,540,713
Realized gain on risk management contracts (note 11(a))	4,475,219	646,141	3,703,948	1,521,501
Unrealized gain (loss) on risk management contracts (note 11(a))	1,527,977	(1,116,245)	1,420,513	75,603
	17,987,740	7,181,170	36,879,165	28,137,817
Expenses				
Operating	3,387,342	3,252,748	9,618,680	11,057,196
Transportation	460,307	192,385	1,090,105	594,129
General and administrative	918,308	968,127	3,223,958	2,803,400
Exploration and evaluation	426,525	121,052	4,832,680	1,609,137
Property, plant and equipment Impairment (note 7)	2,000,000	-	4,500,000	-
Depletion and depreciation	2,948,985	3,262,973	8,335,910	9,817,999
Accretion (note 14)	150,355	162,390	491,939	580,242
Interest and other financing charges (note 14)	102,913	242,071	553,264	857,778
Share-based compensation	373,073	392,325	1,008,270	706,064
Gain on sale of property	-	(1,282,406)	(31,141)	(1,282,406)
Foreign exchange (gain) loss	(992,713)	30,498	(791,760)	(45,842)
	9,775,095	7,342,163	32,831,905	26,697,697
Income (loss) before income tax	8,212,645	(160,993)	4,047,260	1,440,120
Deferred tax expense	1,778,741	192,433	2,541,285	1,287,924
Net income (loss) for the period	6,433,904	\$ (353,426)	\$ 1,505,975	\$ 152,196
Income (loss) per share				
Basic	\$ 0.04	\$ (0.00)	\$ 0.01	\$ 0.00
Diluted	\$ 0.04	\$ (0.00)	\$ 0.01	\$ 0.00

Condensed Interim Consolidated Statement of Comprehensive Income (Loss)
(unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2011	2010	2011	2010
Net income (loss) for the period	\$ 6,433,904	\$ (353,426)	\$ 1,505,975	\$ 152,196
Translation gain (loss) on foreign operations	468,965	(78,136)	258,544	(102,036)
Comprehensive income (loss)	\$ 6,902,869	\$ (431,562)	\$ 1,764,519	\$ 50,160

The notes are an integral part of these condensed interim consolidated financial statements.

Arsenal Energy Inc.

Condensed Interim Consolidated Statements of Changes in Shareholder' Equity (unaudited)

	Number of Shares	Share capital	Contributed surplus	Accumulated other comprehensive income	Deficit	Total Shareholders' equity
Balance January 1, 2011	140,812,472	\$122,609,238	\$7,374,054	\$(199,996)	\$(89,275,562)	\$40,507,734
Net income for the period	-	-	-	-	1,505,975	1,505,975
Issue of shares	22,158,500	21,050,575	-	-	-	21,050,575
Share issue costs	-	(1,280,512)	-	-	-	(1,280,512)
Share-based compensation expensed	-	-	1,008,270	-	-	1,008,270
Share-based compensation capitalized	-	-	200,834	-	-	200,834
Transfer of share-based compensation on exercise of options	-	420,529	(420,529)	-	-	-
Issued on exercise of options	1,192,833	497,807	-	-	-	497,807
Repurchase of shares	(4,797,743)	(4,189,533)	767,114	-	-	(3,422,419)
Translation gain on foreign operations	-	-	-	258,544	-	258,544
Balance September 30, 2011	159,366,062	\$139,108,104	\$8,929,743	\$58,548	\$(87,769,587)	\$60,326,808

	Number of Shares	Share capital	Contributed surplus	Accumulated other comprehensive loss	Deficit	Total Shareholders' equity
Balance January 1, 2010	120,461,890	\$106,471,683	\$6,170,547	\$ -	\$(82,984,243)	\$29,657,987
Net income for the period	-	-	-	-	152,196	152,196
Issue of shares	14,283,000	12,278,550	-	-	-	12,278,550
Share issue costs	-	(772,083)	-	-	-	(772,083)
Share-based compensation expensed	-	-	706,064	-	-	706,064
Share-based compensation capitalized	-	-	115,415	-	-	115,415
Transfer of share-based compensation on exercise of options	-	40,666	(40,666)	-	-	-
Issued on exercise of options	96,500	47,650	-	-	-	47,650
Repurchase of shares	(1,106,918)	(917,208)	14,855	-	-	(902,353)
Translation loss on foreign operations	-	-	-	(102,036)	-	(102,036)
Balance September 30, 2010	133,734,472	\$117,149,258	\$6,966,215	\$(102,036)	\$(82,832,047)	\$41,181,390

The notes are an integral part of these condensed interim consolidated financial statements.

Arsenal Energy Inc.

Condensed Interim Consolidated Statements of Cash Flows
(unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2011	2010	2011	2010
		(note 18)		(note 18)
Cash provided by (used in):				
Operations:				
Net income (loss) for the period	\$6,433,904	\$(353,426)	\$1,505,975	\$152,196
Items not affecting cash:				
Unrealized (gain) loss on risk management contracts	(1,527,977)	1,116,245	(1,420,513)	(75,603)
Depletion and depreciation	2,948,985	3,262,973	8,335,910	9,817,999
Accretion	150,355	162,390	491,939	580,242
Deferred tax expense	1,778,741	192,433	2,541,285	1,287,924
Property, plant and equipment impairment	2,000,000	-	4,500,000	-
Share-based compensation	373,073	392,325	1,008,270	706,064
Unrealized foreign exchange (gain) loss	(1,157,630)	22,126	(931,028)	35,000
Exploration and evaluation expense	400,678	-	4,070,993	-
Gain on sale of property	-	(1,282,406)	(31,141)	(1,282,406)
Decommissioning obligations settled (note 9)	(201,220)	(365,112)	(507,887)	(993,664)
	11,198,909	3,147,548	19,563,803	10,227,752
Net change in non-cash working capital (note 13)	180,076	873,199	2,865,409	(4,503,926)
	11,378,985	4,020,747	22,429,212	5,723,826
Financing:				
Bank loan (repayments)	(3,007,645)	(6,275,000)	(7,678,345)	(8,847,700)
Issue of shares for cash	-	-	21,050,575	12,590,550
Issue of shares on exercise of stock options	-	-	497,807	47,650
Repurchase of shares	(1,642,180)	(359,645)	(3,422,419)	(902,353)
Share issue costs	-	-	(1,690,231)	(1,033,910)
Net change in non-cash working capital items (note 13)	496	37,332	27,136	35,444
	(4,649,329)	(6,597,313)	8,784,523	1,889,681
Investing:				
Additions to property, plant and equipment	(8,640,485)	(3,413,362)	(20,343,488)	(8,852,129)
Exploration and evaluation expenditures	3,452	(412,194)	(6,549,036)	(4,321,487)
Proceeds on disposition of property, plant and equipment	23,405	5,704,246	621,914	5,919,077
Net change in non-cash working capital items (note 13)	3,436,336	1,074,374	(4,838,770)	(656,552)
	(5,177,292)	2,953,064	(31,109,380)	(7,911,091)
Changes in foreign exchange on cash held in foreign currency	-	(19,359)	-	(69,081)
Change in cash and cash equivalents during the period	1,552,364	357,139	104,355	(366,665)
Cash and cash equivalents, beginning of period	-	602,111	1,448,009	1,325,915
Cash and cash equivalents, end of period	\$ 1,552,364	\$ 959,250	\$ 1,552,364	\$ 959,250

The notes are an integral part of these condensed interim consolidated financial statements.

ARSENAL ENERGY INC

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited)

1. Reporting entity:

Arsenal Energy Inc. ("Arsenal" or the "Company") is an oil and gas exploration, development and production Company based in Calgary, Alberta, Canada. 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. The consolidated financial statements of the Company as at and for the three and nine months ended September 30, 2011 and 2010 comprise the Company and its wholly owned subsidiaries, Arsenal Energy USA Ltd. and Arsenal Energy Holdings are incorporated in the USA and Canada respectively.

2. Basis of preparation:

(a) Statement of compliance:

The interim condensed consolidated financial statements have been prepared in accordance with IAS 34 – Interim Financial Reporting of the International Financial Reporting Standards ("IFRS"). These financial statements are the Company's third IFRS interim consolidated financial statements after its transition to reporting in accordance with IFRS and before the issuance of its first publicly issued annual consolidated IFRS financial statements. IFRS 1 – First-time adoption of International Financial Reporting Standards ("IFRS 1") has been applied to these interim consolidated financial statements. These condensed interim consolidated financial statements use the accounting policies as shown in Note 3 of the Company's interim consolidated financial statements for the three months ended March 31, 2011. These are the accounting policies the Company expects to adopt in its annual consolidated financial statements for the year ended December 31, 2011, with the exception of certain disclosures that are normally required to be included in annual consolidated financial statements which have been condensed or omitted.

An explanation of how the transition to IFRS has affected the reported financial position, financial performance and cash flows of the Company is provided in note 18. The note includes reconciliations of equity and net loss for comparative periods from former Canadian GAAP to IFRS.

The consolidated financial statements were authorized for issue by the Board of Directors on November 7, 2011.

(b) Basis of measurement:

The consolidated financial statements have been prepared on the historical cost basis except for the derivative financial instruments which are measured at fair value.

(c) Functional and presentation currency:

These consolidated financial statements are presented in Canadian dollars, which is the Company's functional currency, its subsidiary Arsenal Energy USA Ltd. has a U.S. dollar functional currency.

(d) Use of estimates and judgements:

The preparation of financial statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts 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.

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Notes to Condensed Interim Consolidated Financial Statements
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2. Basis of preparation (continued):

Reserve estimates including production profiles, future development costs, and discount rates are a critical part of many of the estimated amounts and calculations contained in the financial statements. These estimates are verified by third party professional engineers, who work with information provided by the Company to establish reserve determinations. These determinations are updated at least on an annual basis.

Significant areas of estimation, uncertainty and critical judgments in applying accounting policies that impact the amounts recognized in the interim consolidated financial statements include:

- Impairment testing – estimates of reserves, future commodity prices, future costs, production profiles, discount rates, market value of land.
- Depletion and depreciation - oil and natural gas reserves, including future prices, costs and reserve base to use on calculation of depletion.
- Decommissioning obligations – estimates relating to amounts, likelihood, timing, inflation and discount rates.
- Share-based compensation – forfeiture rates and volatility.
- Derivatives – expected future oil and natural gas prices and expected volatility in these prices; expected interest rates; expected future foreign exchange rates.
- Deferred tax – estimates of reversal of temporary differences, tax rates substantively enacted, and likelihood of assets being realized.

3. Determination of fair values:

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. When applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

(i) Property, plant and equipment and exploration and evaluation assets:

The fair value of property, plant and equipment recognized in a business combination, is based on market values. The market value of property, plant and equipment is the estimated amount for which property, plant and equipment could be exchanged on the acquisition date between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The market value of oil and natural gas interests (included in property, plant and equipment) and exploration and evaluation assets is estimated with reference to the discounted cash flows expected to be derived from oil and natural gas production based on externally prepared reserve reports. The risk-adjusted discount rate is specific to the asset with reference to general market conditions.

(ii) Cash and cash equivalents, accounts receivables, bank loans and accounts payables

The fair value of cash and cash equivalents, accounts receivables, bank loans and accounts payables is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date. At September 30, 2011 and December 31, 2010, the fair value of these balances approximated their carrying value due to their short term to maturity. Bank loans bear a floating rate of interest therefore carrying value approximates fair value.

ARSENAL ENERGY INC

Notes to Condensed Interim Consolidated Financial Statements
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3. Determination of fair values (continued):

(iii) Derivatives:

The fair value of forward contracts and swaps is determined by discounting the difference between the contracted prices and published forward price curves as at the balance sheet date, using the remaining contracted oil and natural gas volumes and a risk-free interest rate (based on published government rates). The fair value of options and costless collars is based on option models that use published information with respect to volatility, prices and interest rates.

(iv) Stock options:

The fair value of employee stock options is measured using a Black Scholes option pricing model. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility (based on weighted average historic volatility adjusted for changes expected due to publicly available information), weighted average expected life of the instruments (based on historical experience and general option holder behavior), expected dividends and the risk-free interest rate (based on government bonds).

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 in 2011, the Company incurred a total of \$194,017 (2010 - \$152,977) for legal fees and disbursements. As at September 30, 2011, accounts payable and accrued liabilities include \$25,000 (December 31, 2010 - \$35,000) relating to these payments.

A Director of the Company is a partner in a law firm that provides legal services to the Company. During the first nine months in 2011, the Company recorded a total of \$2,362 (2010 - \$587) for legal fees and disbursements. As at September 30, 2011 accounts payable and accrued liabilities include \$nil (December 31, 2010 - \$nil) relating to these payments.

5. Exploration and evaluation assets:

Cost or deemed cost	Total
Balance at January 1, 2010	\$ -
Additions	10,701,375
Transfer to property, plant and equipment	(3,718,941)
Transfer to exploration and evaluation expenses	(587,929)
Balance at December 31, 2010	6,394,505
Additions	6,549,036
Transfer to property, plant and equipment	(2,810,019)
Transfer to exploration and evaluation expenses	(3,720,467)
Balance at September 30, 2011	\$ 6,413,055

For the nine months ended September 30, 2011, \$761,687 (2010 - \$1,609,137) of seismic costs were recorded directly to exploration and evaluation expense.

Exploration and evaluation (E&E) assets consist of the Company's exploration projects which are pending the determination of proved or probable reserves. Additions represent the Company's share of costs incurred on E&E assets during the period.

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Notes to Condensed Interim Consolidated Financial Statements
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6. Property, plant and equipment:

Cost or deemed cost	Total
Balance at January 1, 2010 (after transitional impairment)	\$77,989,725
Additions	15,960,292
Property acquisitions	2,259,529
Transfer from exploration and evaluation assets	3,718,941
Divestitures	(7,969,065)
Change in decommissioning obligations	1,109,054
Impairment	(5,948,300)
Capitalized share-based compensation	211,130
Changes in translation of foreign operations	(807,563)
Balance at December 31, 2010	\$86,523,743
Additions	20,504,667
Transfer from exploration and evaluation assets	2,810,019
Divestitures	(1,218,353)
Impairment	(4,500,000)
Capitalized share-based compensation	200,834
Change in decommissioning obligations	1,786,246
Change in translation of foreign operations	2,191,213
Balance at September 30, 2011	\$108,298,369

Accumulated Depreciation	Total
Balance at January 1, 2010	\$ -
Depletion and depreciation expense	12,858,312
Divestitures	(606,000)
Changes in translation of foreign operations	(59,595)
Balance at December 31, 2010	12,192,717
Depletion and depreciation expense	8,335,910
Divestitures	(211,000)
Change in translation of foreign operations	207,202
Balance at September 30, 2011	\$20,524,829

Net book value	Total
Balance, December 31, 2010	\$74,331,026
Balance, September 30, 2011	\$87,773,540

Future development and decommissioning costs of \$26.4 million (December 31, 2010 - \$37.8 million) associated with the development and decommissioning of the Company's proved plus probable reserves are included in the depletion calculation but excludes salvage value of \$6.0 million (December 31, 2010 - \$6.3 million).

During the nine months ended September 30, 2011, the Company disposed of certain non-core properties for proceeds of \$621,914 (December 31, 2010 \$5,919,077), this resulted in a gain of \$31,141 (December 31, 2010 \$1,282,406).

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Notes to Condensed Interim Consolidated Financial Statements
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7. Impairment loss:

During the nine months ended September 30, 2011, as a result of limited reserve additions, Arsenal recognized a \$4.5 million impairment in certain CGU's. The impairments were based on the difference between the period end net book value of the assets and the recoverable amount. The recoverable amount was determined using fair value less costs to sell, based on discounted cash flows of proved plus probable reserves using forecast prices and costs.

8. Bank loan:

As at September 30, 2011, the Company's credit facility was reviewed, syndicated and increased from \$40.0 million to \$60.0 million based on the independent engineering report as at December 31, 2010. The credit facility is available in Canadian and/or US dollar prime loans or in Bankers Acceptances' and/or Libor borrowings. Interest on the Company's credit facility is at rates ranging from Canadian or US prime plus 1.00% to 2.50% on prime based loans and from the base rate plus 2.00% to 3.50% on Bankers Acceptances' and on Libor based loans. The interest rate is set based on the Company's debt, as calculated for this purpose to include bank loan plus working capital (excess or deficiency), outstanding letters of credit and other miscellaneous items but excludes decommissioning obligations and risk management contracts (whether an asset or an obligation) to trailing funds flow ratio (funds flow for the last two quarters annualized) adjusted for any unusual or non-recurring items as determined by the lender.

The credit facility has a revolving period of 364 days plus one year and is extendible annually. If not extended, the credit facility will automatically convert to a one year non-revolving term loan and all obligations under the credit facility shall be repaid or paid at the end of the one year period.

The credit facility is secured by an unlimited liability guarantee to the lenders, a ISDA Master Agreement, a demand debenture in the amount of \$300,000,000 granting a first priority security interest over all present and after acquired personal property and a first floating charge over all present and after acquired petroleum and natural gas interests and mortgages creating specific fixed charges on some of the oil and gas properties of the Company in North Dakota.

The credit facility is also subject to certain positive and negative covenants including a covenant not to dispose of assets or property having a fair aggregate value not exceeding 5% of the borrowing base with no adjustment to the borrowing base. In addition, the credit facility is subject to a semiannual borrowing base review based on internally generated engineering.

At September 30, 2011, debt under the credit facility amounted to \$3,915,690 and includes \$3,000,000 of US dollar denominated borrowings.

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

- The adjusted working capital ratio (as defined in the agreement to include the unutilized portion of the facility and to exclude the value of any risk management contracts) to fall to below 1 : 1.

At September 30, 2011, the Company was in compliance with this covenant.

ARSENAL ENERGY INC

Notes to Condensed Interim Consolidated Financial Statements
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9. Decommissioning Obligations:

	Nine months ended September 30, 2011	Year ended December 31, 2010
Decommissioning obligations, beginning of period	\$ 19,667,331	\$ 21,182,129
Obligations settled	(507,887)	(1,083,837)
Obligations acquired	-	20,216
Obligations disposed	(435,710)	(2,726,393)
Obligations incurred	532,218	683,760
Change in estimated future cash outflows/discount rate	1,786,246	1,109,054
Foreign currency translation	331,851	(273,639)
Accretion expense	491,939	756,041
Decommissioning obligations, end of period	\$ 21,865,988	\$ 19,667,331

The Company's decommissioning obligations result from its ownership interest in oil and natural gas assets including well sites and gathering systems. The total decommissioning obligations are estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities and the estimated timing of the costs to be incurred in future years. The Company has estimated the net present value of the decommissioning obligations to be \$21.6 million as at September 30, 2011 (December 31, 2010: \$19.7 million) based on an undiscounted inflation adjusted total future liability of \$30.9 million (December 31, 2010 - \$32.1 million). These payments are expected to be made over the next 25 years with the majority of costs to be incurred between 2012 and 2022. The discount factor, being the risk free rate related to the liability, is 2.8% (December 31, 2010 3.5%).

10. Share capital:

At September 30, 2011, the Company was authorized to issue an unlimited number of common shares with the holders of common shares being entitled to one vote per share.

(a) Issued

	Nine months ended September 30, 2011		Year ended December 31, 2010	
	Number of Shares	Share capital	Number of Shares	Share Capital
Balance, beginning of period	140,812,472	\$122,609,238	120,461,890	\$106,471,683
Issue of shares	22,158,500	21,050,575	21,583,000	18,315,650
Share issue costs	-	(1,280,512)	-	(1,161,279)
Transfer of share-based compensation on exercise of options	-	420,529	-	65,318
Issued on exercise of options	1,192,833	497,807	171,500	79,150
Repurchase of shares	(4,797,743)	(4,189,533)	(1,403,918)	(1,161,284)
Balance, end of period	159,366,062	\$139,108,104	140,812,472	\$122,609,238

ARSENAL ENERGY INC

Notes to Condensed Interim Consolidated Financial Statements
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10. Share capital (continued):

Common Shares

On February 15, 2011, the Company issued 22,158,500 common shares at \$0.95 per share for gross proceeds of \$21,050,575.

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

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. 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 September 30, 2010, approximately \$750,000 in exploration costs had yet to be incurred.

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. 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, all exploration costs had been incurred on this issuance.

(b) Share based payments

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 follows:

	Number of options	Weighted average exercise price
Balance, January 1, 2010	9,322,000	\$ 0.55
Granted	4,280,000	0.88
Exercised	(171,500)	0.46
Expirations	(640,000)	1.23
Forfeited	(36,000)	0.37
Balance, December 31, 2010	12,754,500	\$ 0.62
Granted	4,690,000	0.68
Exercised	(1,192,833)	0.42
Expirations	(390,000)	1.09
Forfeited	(1,167,997)	0.72
Balance, September 30, 2011	14,693,670	\$ 0.64

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Notes to Condensed Interim Consolidated Financial Statements
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10. Share capital (continued):

The following table summarizes information about the stock options outstanding and exercisable at September 30, 2011:

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	1,278,000	\$ 0.21	2.25	850,668	\$ 0.21	
\$0.36 to \$0.50	2,799,670	0.40	2.28	1,629,001	0.40	
\$0.51 to \$0.70	4,626,000	0.63	3.93	1,086,000	0.61	
\$0.71 to \$1.00	5,990,000	0.86	3.56	2,213,334	0.84	
Total	14,693,670	\$ 0.64	3.32	5,779,003	\$ 0.57	

Options granted to employees and non-employees are accounted for using the fair value method. The fair value of stock options was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Risk free rate	1.39 - 2.25%	2.05 - 2.9%
Expected life	4 years	4 years
Expected volatility	87 - 92%	87%
Expected dividend	nil	nil
Expected forfeitures	5%	5%

(c) Income (loss) per share

	Three Months Ended September 30		Nine Months Ended September 30	
	2011	2010	2011	2010
Basic and diluted:				
Income (loss) per share				
basic and diluted	\$0.04	(\$0.00)	\$0.01	\$0.00
Shares outstanding:				
Basic	161,363,535	134,006,733	158,762,112	131,578,389
Diluted	163,563,282	134,006,733	161,590,075	134,684,408

In computing diluted earnings per share for the nine months ended September 30, 2011, 11,865,707 (2010- 9,823,481) options were excluded from the dilution calculations as they were anti-dilutive. In computing diluted earnings per share for the three months ended September 30, 2011, 12,493,923 (2010- 12,929,500) options were excluded from the dilution calculations as they were anti-dilutive.

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10. Share capital (continued):

(d) 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. During the nine months ended September 30, 2011, the Company acquired 1,571,000 common shares at a cost of \$1,236,750 or \$0.79 per share plus expenses. The stated value of these shares exceeded the cost by \$136,115 and has been recorded to contributed surplus.

On June 16, 2011, the Company announced its intention to make a normal course issuer bid ("NCIB") that commenced June 20, 2011 and ends June 19, 2012. A total of 8,128,724 common shares may be acquired under the bid representing 5% of the common shares outstanding as of June 14, 2011. To date, the Company has purchased 3,226,743 common shares at a cost of \$2,185,668 or \$0.68 per share plus expenses. The stated value of these shares exceeded the cost by \$630,999 and has been recorded to contributed surplus.

11. 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 September 30, 2011, the Company had no crude oil swaps in-place as all remaining outstanding contracts were monetized August 9, 2011. For the nine months ended September 30, 2011, the Company recorded a realized commodity contract gain of \$3,703,948 (September 30, 2010 - \$1,521,501 gain) and an unrealized commodity contract gain of \$1,420,513 (September 30, 2010 - \$75,603 gain).

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

	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Total fair value consists of the following:		
Fair value, end of period - current portion	\$ -	\$ 325,892
Fair value, end of period - long-term portion	\$ -	\$ (246,911)
Total fair value, end of period	\$ -	\$ 78,981

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11. Risk management and financial instruments (continued):

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	
	2011	2010	2011	2010
Fair value, beginning of period	(\$1,527,977)	\$1,195,226	(\$1,420,513)	\$ 3,378
Changes in fair value	6,003,255	(470,104)	5,124,477	1,597,104
Settlement paid (received)	(4,475,278)	(646,141)	(3,703,964)	(1,521,501)
Fair value, end of year	-	\$78,981	-	\$78,981

On October 25 and 26, 2011, the Company entered into two crude oil commodity price contracts to sell 300 and 400 barrels of production per day from November 1, 2011 until December 31, 2013 at a price of \$92.10 per barrel.

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.

12. 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

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12. Capital management (continued):

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 shareholder's equity, bank loan and working capital (excess or deficiency) 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, or reviewing the advisability of fixing, interest rates and commodity prices on all or a portion of the Company's debt and production, by closely monitoring expenses and by closely monitoring and scrutinizing the results of its capital expenditure program and adjusting capital expenditures as required based on economic conditions and drilling results.

The Company monitors its capital base based primarily on its debt to annualized funds flow ratio and its debt to equity ratio. Debt includes bank borrowings, plus or minus working capital and excludes decommissioning obligations and risk management contracts (whether an asset or an obligation). Annualized funds flow is calculated as cash flow from operations before changes in non-cash working capital, decommissioning obligations settled and exploration and evaluations expenses from the Company's most recent quarter multiplied by four adjusted, if required, by increasing or decreasing commodity price expectations, future production profiles, the Company's risk management position and other non-recurring items. The Company's goal is to target this ratio at 1 : 1 but the ratio 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, it is expected that the ratio would decrease. The Company's focus in these instances is to concentrate on bringing the ratio back into the target range. The ratio represents the time period it would take to pay off the debt if no further capital expenditures were incurred and if funds from operations remained constant. The Company prepares an annual operating and capital expenditure budget. The budget is updated when critical factors change and when actual results are realized and compared to budget. 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, 2011, the Company's net debt to annualized funds flow ratio was 0.39 : 1 and its debt to equity ratio was 0.15 : 1. Conversion to IFRS reduced equity by approximately \$28.1 million primarily as a result of the fair value assessment by CGU and the adjustment to decommissioning obligations. An equity issue generating net proceeds of approximately \$19.8 million in February 2011 increased equity and reduced debt improving the debt to annualized funds flow ratio and the debt to equity ratio at year end. At June 30, 2011, both the net debt to annualized funds flow ratio and the debt to equity ratio are lower than the target range as established in management's strategic 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, 2011, the Company has complied with this external financial covenant.

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12. Capital management (continued):

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 anticipate doing so in the foreseeable future.

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

Net debt	September 30, 2011	September 30, 2010
Cash and cash equivalents	\$ 1,552,364	\$ 959,250
Accounts receivable and prepaids	9,760,937	8,700,232
Accounts payable and accrued liabilities	(16,637,621)	(11,350,534)
Working capital deficiency	\$ (5,324,320)	\$ (1,691,052)
Bank loan	(3,915,960)	(13,370,000)
Net debt	\$ (9,240,010)	\$ (15,061,051)
Annualized funds flow ^{1,2}	\$ 23,505,566	\$ 12,875,986
Net debt to annualized funds flow ratio	0.39	1.17
Shareholders' equity	\$ 60,326,808	\$ 41,181,390
Debt to equity	0.15	0.37

¹ Excludes realized gain on commodity contracts

² Based on the last two quarters annualized funds flow

13. Supplemental cash flow information:

Nine Months ended September 30	2011	2010
Change in non-cash working capital items:		
Accounts receivable	\$ (1,297,696)	\$ (1,745,153)
Prepaid expenses and deposits	34,670	47,774
Accounts payable and accrued liabilities	(683,199)	(3,427,655)
	(1,946,225)	(5,125,034)
Amounts relating to operating activities	2,865,409	(4,503,926)
Amounts relating to financing activities	27,136	35,444
Amounts relating to investing activities	(4,838,770)	(656,552)
	(1,946,225)	(5,125,034)
Interest paid	\$ 151,477	\$ 640,387

14. Finance expenses:

	Three Months Ended September 30		Nine Months Ended September 30	
	2011	2010	2011	2010
Accretion of decommissioning obligation	\$ 150,355	\$ 162,390	\$ 491,939	\$ 580,242
Interest and other financing fees	102,913	242,071	553,264	857,778
	\$ 253,268	\$ 404,461	\$1,045,203	\$1,438,020

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15. 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, 2011 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	23,291,725	16,084,803	39,376,528
Income (loss) before income taxes	(3,400,897)	7,448,157	4,047,260
Operating income ¹	11,863,822	9,182,097	21,045,919
Exploration and evaluation assets	6,413,055	-	6,413,055
Property, plant and equipment	52,807,120	34,966,420	87,773,540
Capital expenditures	5,105,244	15,238,244	20,343,488
Exploration and evaluation expenditures ²	6,549,036	-	6,549,036
Property dispositions	(621,914)	-	(621,914)

September 30, 2010 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	21,386,309	11,029,268	32,415,577
Income (loss) before income taxes	(1,778,345)	3,218,465	1,440,120
Operating income ¹	9,137,469	5,751,919	14,889,388
Exploration and evaluation assets	2,748,537	-	2,748,537
Property, plant and equipment ³	57,833,695	14,538,724	72,372,419
Capital expenditures	3,745,058	5,107,071	8,852,129
Exploration and evaluation expenditures ²	5,877,193	53,431	5,930,624
Property dispositions	(5,919,077)	-	(5,919,077)

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

² Includes dry holes and seismic expenditures

³ As at December 31, 2010

16. 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 September 30, 2011, the Company had approximately \$750,000 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	\$	142,717
2012		385,421
2013		40,430
Total commitment	\$	568,568

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16. Commitments and contingencies (continued):

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.

17. Subsequent event:

On October 26, 2011 the Company entered into an agreement to purchase certain producing properties for total cash consideration of \$40.25 million, and is scheduled to close on November 15, 2011.

18. Reconciliation of equity and income from Canadian GAAP to IFRS:

The adoption of IFRS requires the application of IFRS 1. IFRS 1 generally requires that an entity retrospectively apply all IFRS effective at the end of its first IFRS reporting period; however IFRS 1 provides certain mandatory exceptions and permits limited optional exemptions. Certain IFRS 1 optional exemptions have been applied including:

- Deemed cost exemption for full cost oil and gas entities whereby exploration and evaluation assets were classified from the full cost pool to intangible exploration assets at the amount that was recorded under previous GAAP and the remaining full cost pool was allocated to the development assets and components pro rata using reserve volumes.
- Decommissioning obligations exemption that allows any changes in decommissioning obligations on transition to IFRS to be adjusted through opening deficit.
- Stock-based compensation exemption that allows a company to only have to evaluate share based compensation awards that were unvested as of the date of transition and that were issued subsequent to November 7, 2002.
- Business combinations exemption that allows a company to not have to restate any business combinations that occurred prior to the date of transition.
- Cumulative translation option that allows losses to be reset to zero with the adjustment going through opening deficit.

The accounting policies in note 3 of the condensed interim consolidated financial statements for the three months ended March 31, 2011 have been applied in preparing the condensed interim consolidated financial statements for the three and nine months ended September 30, 2011 and the comparative information for the three and nine months ended September 30, 2010.

In preparing its comparative information for the three and nine months ended September 30, 2010, the Company adjusted amounts previously reported in financial statements prepared in accordance with former Canadian GAAP. An explanation of how the transition from former Canadian GAAP to IFRS has affected the Company's financial position, financial performance and cash flows is set out in the following tables and the notes accompanying the tables.

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18. Reconciliation of equity and income from Canadian GAAP to IFRS (continued):

As at September 30, 2010:

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
Assets				
Current assets:				
Cash and cash equivalents		\$ 959,250	\$ -	\$ 959,250
Accounts receivable		8,215,198	-	8,215,198
Prepaid expenses and deposits		485,034	-	485,034
Risk management contracts		325,892	-	325,892
		9,985,374	-	9,985,374
Reclamation deposit		154,350	-	154,350
Exploration and evaluation assets	B	-	2,748,537	2,748,537
Property, plant and equipment	B,C	94,312,946	(21,940,527)	72,372,419
Deferred taxes	A	-	1,775,276	1,775,276
		\$104,452,670	\$ (17,416,714)	\$ 87,035,956
Liabilities				
Current liabilities:				
Accounts payable and accrued liabilities		\$11,350,534	\$ -	\$ 11,350,534
Bank loan		13,370,000	-	13,370,000
Deferred taxes	A	94,508	(94,508)	-
		24,815,042	(94,508)	24,720,534
Flow through share premium	F	-	454,036	454,036
Risk management contracts		246,911	-	246,911
Deferred taxes	A,C,E,F	6,791,963	(5,561,512)	1,230,451
Decommissioning obligations	E	12,044,590	7,158,044	19,202,634
		43,898,506	1,956,060	45,854,566
Shareholders' Equity				
Common shares	F	110,695,561	6,453,697	117,149,258
Contributed surplus	G	6,605,203	361,012	6,966,215
Accumulated other comprehensive loss	I	(622,992)	520,956	(102,036)
Deficit	A,C,E,I	(56,123,608)	(26,708,439)	(82,832,047)
		60,554,164	(19,372,774)	41,181,390
		\$104,452,670	\$ (17,416,714)	\$ 87,035,956

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18. Reconciliation of equity and income from Canadian GAAP to IFRS (continued):

Reconciliation of consolidated statement of loss and comprehensive loss for the nine months ended September 30, 2010:

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
Revenues:				
Oil and natural gas revenue		\$32,415,577	\$ -	\$32,415,577
Royalties		(5,874,864)	-	(5,874,864)
		26,540,713	-	26,540,713
Realized gain on risk management contracts		1,521,501	-	1,521,501
Unrealized gain on risk management contracts		75,603	-	75,603
		28,137,817	-	28,137,817
Expenses:				
Operating	C	10,711,375	345,821	11,057,196
Transportation		594,129	-	594,129
General and administrative		2,803,400	-	2,803,400
Exploration and evaluation	C	-	1,609,137	1,609,137
Depletion and depreciation	C, D	21,319,505	(11,501,506)	9,817,999
Accretion on decommissioning obligation		802,581	(222,339)	580,242
Finance expenses		857,778	-	857,778
Share-based compensation	G	553,527	152,537	706,064
Gain on property divestiture		-	(1,282,406)	(1,282,406)
Foreign exchange (gain) loss		(45,842)	-	(45,842)
		37,596,453	(10,898,756)	26,697,697
Income (loss) before tax		(9,458,636)	(10,898,756)	1,440,120
Deferred tax (benefit)	C,E,F	(2,017,238)	3,305,162	1,287,924
Net income (loss) for the period		\$(7,441,398)	\$ 7,593,594	\$ 152,196
Translation loss on foreign operations		(115,486)	13,450	(102,036)
Comprehensive income (loss)		\$ (7,556,884)	\$ 7,607,044	\$ 50,160
Income (loss) per share:				
Basic		\$ (0.06)		\$ (0.00)
Diluted		\$ (0.06)		\$ (0.00)

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18. Reconciliation of equity and income from Canadian GAAP to IFRS (continued):

Reconciliation of consolidated statement of loss and comprehensive loss for the three months ended September 30, 2010:

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
Revenues:				
Oil and natural gas revenue		\$ 9,701,018	\$ -	\$ 9,701,018
Royalties		(2,049,744)	-	(2,049,744)
		7,651,274	-	7,651,274
Realized gain on risk management contracts		646,141	-	646,141
Unrealized loss on risk management contracts		(1,116,245)	-	(1,116,245)
		7,181,170	-	7,181,170
Expenses:				
Operating	C	3,110,135	142,613	3,252,748
Transportation		192,385	-	192,385
General and administrative		968,127	-	968,127
Exploration and evaluation	C	-	121,052	121,052
Depletion and depreciation	C, D	7,114,292	(3,851,319)	3,262,973
Accretion on decommissioning obligation		245,232	(82,842)	162,390
Finance expenses		242,071	-	242,071
Share-based compensation	G	274,254	118,071	392,325
Gain on property divestiture		-	(1,282,406)	(1,282,406)
Foreign exchange (gain) loss		30,498	-	30,498
		12,176,994	(4,834,831)	7,342,163
Income (loss) before tax		(4,995,824)	(4,834,831)	(160,993)
Deferred tax (benefit)	C,E,F	(1,167,557)	1,361,990	192,433
Net income (loss) for the period		\$(3,828,267)	\$ 3,472,841	\$ (353,426)
Translation loss on foreign operations		(113,112)	34,976	(78,136)
Comprehensive income (loss)		\$ (3,941,379)	\$ 3,509,817	\$ (431,562)
Income (loss) per share:				
Basic		\$ (0.03)		\$ (0.00)
Diluted		\$ (0.03)		\$ (0.00)

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18. Reconciliation of equity and income from Canadian GAAP to IFRS (continued):

Impact of transition to IFRS and 2010 results

- (A) Under IFRS, all deferred tax assets and liabilities are classified as long-term. Under previous GAAP, deferred tax assets and liabilities were presented according to the classification of the underlying asset or liability that created the difference in the deferred tax amount.
- (B) Exploration and Evaluation assets ("E&E") – As required under IFRS 6, Arsenal reclassified \$2.7 million from Property, Plant and Equipment ("PP&E") to E&E at September 30, 2010 and \$6.4 million at December 31, 2010. No costs were reclassified upon transition.
- (C) Under IFRS, impairment tests for PP&E are performed at a CGU level as opposed to the entire Company's PP&E balance being subjected to a full cost ceiling test under previous GAAP. Impairment is recognized if the carrying value exceeds the recoverable amount for a CGU. The recoverable amount is determined using the greater of the fair value less costs to sell based on discounted future cash flows of proved plus probable reserves using forecast prices and costs, and the value in use. Upon transition to IFRS, Arsenal recognized a \$30.3 million impairment which was charged to the opening deficit. As a result of decreased forward natural gas prices and a downward revision of reserves in a certain CGU, Arsenal recognized a \$5.9 million impairment for the year ended December 31, 2010. This resulted in a reduction of PP&E with the offset charged to property, plant and equipment impairment.

The related income tax effect of the above noted adjustments have also been reflected in these statements.

Upon transition to IFRS Arsenal has also chosen to expense all dry holes, seismic expenditures and lease rentals. This resulted in \$2.2 million of dry holes and seismic expenditures being charged to exploration and evaluation expenditures in 2010 (September 30, 2010 - \$1.6 million) and \$423,135 of lease rentals being charged to operating expenses in 2010 (September 30, 2010 - \$323,797).

- (D) Depletion and depreciation expense – Under IFRS, Arsenal has chosen to calculate depletion expense based on proved plus probable reserves as opposed to proved reserves under previous GAAP. This has resulted in a reduction of depletion and depreciation expense of approximately \$15.0 million in 2010 (September 30, 2010 - \$11.5 million).
- (E) Decommissioning obligations – Under previous GAAP, Arsenal's decommissioning obligations were discounted based on a credit adjusted risk-free rate of 8% at December 31, 2009. Under IFRS, the Company is required to revalue its obligation at each balance sheet date using a current liability-specific discount rate. At transition, Arsenal revalued the obligation based on a risk-free rate of 4% resulting in a \$7.1 million increase to the liability with the offset charged to deficit. A further change in the discount rate at September 30, 2010 resulted in a revaluation to increase the liability by \$1.1 million. As a result of the change in the discount rate applied, accretion of decommissioning obligation expense decreased by \$270,045 for the year ended December 31, 2010 (September 30, 2010 - \$222,339).
- (F) Under previous GAAP, the deferred tax liability associated with the renouncement of tax deductions from the issuance of flow through shares was recorded as a reduction in share capital at the time of renouncement. Under IFRS, the difference between the deferred tax

ARSENAL ENERGY INC

Notes to Condensed Interim Consolidated Financial Statements
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18. Reconciliation of equity and income from Canadian GAAP to IFRS (continued):

liability associated with the renouncement of the tax deductions and the premium price received on the issuance of flow through shares over the market value of the Company's common shares at the time of issue is recorded as a deferred tax expense as the expenditures are incurred. This deferred tax expense represents the net loss on the distribution of the tax deductions to investors. The transitional adjustment resulted in an increase of \$5.5 million (September 30, 2010 - \$6.4million and December 31, 2010 - \$ 5.4 million) to share capital with a resulting offset being charged to deficit.

For the year ended December 31, 2010, a deferred tax expense of \$1.1 million (September 30, 2010 - \$1.3 million) was recognized as a result of changes in the temporary difference between the net book value and the tax basis of the assets and liabilities.

- (G) Under previous GAAP, Arsenal expensed stock-based compensation on a straight-line basis. Under IFRS, share-based payments are expensed based on a graded vesting schedule. Arsenal also incorporated a forfeiture multiplier rather than accounting for forfeitures as they occur as currently practiced under previous GAAP. The adjustment to contributed surplus to account for the graded vesting and forfeitures was an increase of \$189,946 with the offset being charged to deficit. This resulted in a \$152,537 increase for the nine months ended September 30, 2010 and a \$233,588 increase to stock-based compensation expense for the year ended December 31, 2010.
- (H) Divestitures – Under previous GAAP, proceeds from divestitures were deducted from the full cost pool without recognition of a gain or loss unless the divestiture resulted in a change in the depletion rate of 20% or greater in which case, a gain or loss was recorded. Under IFRS, gains and losses are recorded on divestitures and are calculated as the difference between the proceeds and the net book value of the asset disposed of.

For the year ended December 31, 2010, the Company recorded a \$1.2 million (September 30, 2010 - \$1.2) gain on disposition of oil and gas properties for IFRS as compared to nil under previous GAAP. During the third quarter of 2010, the Company disposed of oil and gas properties in British Columbia and Wildmere with a combined net book value of \$6.8 million.

- (I) Cumulative translation losses – Upon transition to IFRS, Arsenal elected to reset cumulative translation losses to zero with the adjustment going through opening deficit.
- (J) Cash flow statement – Upon transition to IFRS, there were no significant changes to the operating, investing and financing cash flows other than the adjustments related to the expensing of dry holes, seismic and lease rentals.