

Consolidated Financial Statements of

ARSENAL ENERGY INC.

Years ended December 31, 2012 and 2011

MANAGEMENT'S REPORT

Management, in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board, has prepared the accompanying consolidated financial statements of Arsenal Energy Inc. (the "Company"). Financial and operating information presented throughout this report is consistent with that shown in the consolidated financial statements.

Management is responsible for the integrity of the financial information. Internal control systems are designed and maintained to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce reliable accounting records for financial reporting purposes.

KPMG LLP was appointed by the Company's shareholders to conduct an audit of the consolidated financial statements so as to express an opinion on the consolidated financial statements. Their examination included such tests and procedures, as they considered necessary, to provide reasonable assurance that the financial statements are presented fairly in accordance with IFRS.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises this responsibility through the Audit Committee, with assistance from the Reserve Committee regarding the annual evaluation of our petroleum and natural gas reserves. The Audit Committee meets regularly with management and the independent auditors to ensure that management's responsibilities are properly discharged, to review the consolidated financial statements and recommend that the consolidated financial statements be presented to the Board of Directors for approval. The Audit Committee also considers the independence of the external auditors and reviews their fees. The external auditors have access to the Audit Committee without the presence of management.

"signed"

Tony van Winkoop

President and Chief Executive Officer

"signed"

J. Paul Lawrence

Vice President Finance and Chief Financial Officer

March 18, 2013

Independent Auditors' Report

To the Shareholders of Arsenal Energy Inc.

We have audited the accompanying consolidated financial statements of Arsenal Energy Inc., which comprise the consolidated statements of financial position as at December 31, 2012 and December 31, 2011, the consolidated statements of loss, comprehensive loss, changes in shareholders' equity and cash flows for the years ended December 31, 2012 and December 31, 2011, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

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

Auditors' responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Arsenal Energy Inc. as at December 31, 2012 and December 31, 2011, and its consolidated financial performance and its consolidated cash flows for the years ended December 31, 2012 and December 31, 2011 in accordance with International Financial Reporting Standards.

Signed "KPMG LLP"

Chartered Accountants
Calgary, Canada
March 18, 2013

Arsenal Energy Inc.

Consolidated Statements of Financial Position

<i>(thousands of \$Cdn)</i>	December 31, 2012	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	\$ -	\$ 626
Accounts receivable	10,610	11,677
Inventory	508	482
Risk management contracts (note 13)	718	-
Prepaid expenses and deposits	804	978
	<hr/> 12,640	<hr/> 13,763
Reclamation deposit	149	153
Exploration and evaluation assets (note 7)	10,754	9,100
Property, plant and equipment (notes 8 and 9)	157,139	146,195
Deferred taxes (note 15)	1,775	1,775
	<hr/> \$182,457	<hr/> \$170,986
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 17,966	\$ 17,453
Risk management contracts (note 13)	-	2,291
	<hr/> 17,966	<hr/> 19,744
Bank loan (note 10)	62,447	52,062
Risk management contracts (note 13)	500	1,485
Decommissioning obligations (note 11)	37,373	37,326
Deferred taxes (note 15)	9,144	5,496
	<hr/> 127,430	<hr/> 116,113
Shareholders' Equity:		
Common shares (note 12(a))	135,646	136,860
Contributed surplus	11,646	9,987
Accumulated other comprehensive loss	(332)	(153)
Deficit	(91,933)	(91,821)
	<hr/> 55,027	<hr/> 54,873
	<hr/> \$182,457	<hr/> \$170,986

Segmented information (note 17)

Commitments and contingencies (note 18)

Subsequent event (note 20)

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

Approved on behalf of the Board of Directors:

“signed”
William Hews
Director

“signed”
R. Neil MacKay
Director

Arsenal Energy Inc.

Consolidated Statements of Loss

For the years ended December 31, 2012 and 2011

<i>(thousands of \$Cdn, except per share amounts)</i>	2012	2011
Revenue		
Oil and gas	\$ 82,168	\$ 58,466
Royalties	(17,064)	(11,778)
	65,104	46,688
Realized gain on risk management contracts (note 13(a))	93	3,357
Unrealized gain (loss) on risk management contracts (note 13(a))	3,993	(2,355)
	69,190	47,690
Expenses		
Operating and transportation	27,630	15,827
General and administrative	4,133	3,972
Exploration and evaluation	902	5,663
Property, plant and equipment impairment (note 9)	1,950	5,500
Depletion and depreciation	24,552	12,894
Share-based compensation	1,078	1,405
Loss (gain) on sale of property (note 8)	662	(31)
	60,907	45,230
Income from operations	8,283	2,460
Financing items		
Interest and other financing charges	2,282	934
Accretion (note 11)	930	708
Transaction costs	1,132	614
Foreign exchange loss (gain)	267	(335)
	4,611	1,921
Income before income tax	3,672	539
Deferred tax expense (note 15)	3,784	3,084
Net loss for the year	\$ (112)	\$ (2,545)
Loss per share (note 12 (c))		
Basic and diluted	\$ (0.00)	\$ (0.02)

Consolidated Statements of Comprehensive Loss

	2012	2011
Net loss for the year	\$ (112)	\$ (2,545)
Translation gain (loss) on foreign operations	(179)	47
Comprehensive loss	\$ (291)	\$ (2,498)

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

Arsenal Energy Inc.

Consolidated Statements of Changes in Shareholders' Equity

<i>(thousands)</i>	Number of Shares	Share capital	Contributed surplus	Accumulated other comprehensive loss	Deficit	Total Shareholders' equity
Balance December 31, 2011	157,282	\$136,860	\$9,987	\$(153)	\$(91,821)	\$54,873
Net loss for the year	-	-	-	-	(112)	(112)
Share-based compensation expensed	-	-	1,079	-	-	1,079
Share-based compensation capitalized	-	-	286	-	-	286
Transfer of share-based compensation on exercise of options (note 12 (a))	-	100	(100)	-	-	-
Issued on exercise of options (note 12 (b))	313	121	-	-	-	121
Repurchase of shares (note 12 (d))	(1,647)	(1,435)	394	-	-	(1,041)
Translation gain on foreign operations	-	-	-	(179)	-	(179)
Balance December 31, 2012	155,948	\$135,646	\$11,646	\$(332)	\$(91,933)	\$55,027

<i>(thousands)</i>	Number of Shares	Share capital	Contributed surplus	Accumulated other comprehensive loss	Deficit	Total Shareholders' equity
Balance December 31, 2010	140,812	\$122,609	\$7,374	\$(200)	\$(89,276)	\$40,507
Net loss for the year	-	-	-	-	(2,545)	(2,545)
Issue of shares (note 12 (a))	22,159	21,050	-	-	-	21,050
Share issue costs (note 12 (a))	-	(1,694)	-	-	-	(1,694)
Share-based compensation expensed	-	-	1,405	-	-	1,405
Share-based compensation capitalized	-	-	298	-	-	298
Transfer of share-based compensation on exercise of options (note 12 (a))	-	470	(470)	-	-	-
Issued on exercise of options (note 12 (b))	1,343	561	-	-	-	561
Repurchase of shares (note 12(d))	(7,032)	(6,136)	1,380	-	-	(4,756)
Translation gain on foreign operations	-	-	-	47	-	47
Balance December 31, 2011	157,282	\$136,860	\$9,987	\$(153)	\$(91,821)	\$54,873

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

Arsenal Energy Inc.

Consolidated Statements of Cash Flows

For the years ended December 31, 2012 and 2011

<i>(thousands of \$Cdn)</i>	Year ended December 31	
	2012	2011
Operating Activities:		
Net loss for the year	\$ (112)	\$ (2,545)
Items not affecting cash:		
Unrealized (gain) loss on risk management contracts	(3,993)	2,355
Depletion and depreciation	24,552	12,894
Accretion	930	708
Deferred tax expense	3,784	3,084
Property, plant and equipment impairment	1,950	5,500
Share-based compensation	1,078	1,405
Unrealized foreign exchange (gain) loss	234	(374)
Loss (gain) on sale of property and equipment	662	(31)
Exploration and evaluation expense	4	4,108
Decommissioning obligations settled (note 11)	(477)	(819)
Net change in non-cash working capital (note 16)	1,088	(1,598)
Net cash from operating activities	29,700	24,687
Financing Activities:		
Bank loan advances	10,565	40,565
Issue of shares for cash, net	-	19,356
Issue of shares on exercise of stock options	121	561
Repurchase of shares	(1,041)	(4,757)
Net change in non-cash working capital items (note 16)	542	(126)
Net cash from financing activities	10,187	55,599
Investing Activities:		
Property, plant and equipment	(36,091)	(31,107)
Exploration and evaluation expenditures	(6,590)	(9,364)
Acquisition of property, plant and equipment	-	(38,575)
Disposition of property, plant and equipment	1,928	622
Net change in non-cash working capital items (note 16)	108	(2,575)
Net cash (used in) investing activities	(40,645)	(80,999)
Foreign exchange gain (loss) on cash held in foreign currency	132	(109)
Change in cash and cash equivalents during the year	(626)	(822)
Cash and cash equivalents, beginning of year	626	1,448
Cash and cash equivalents, end of year	\$ -	\$ 626

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

ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

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 Company conducts its operations in the Western Canadian Sedimentary basin in Canada and Williston basin in the United States. The consolidated financial statements of the Company as at and for the years ended December 31, 2012 and 2011 comprise the Company and its wholly owned subsidiaries, Arsenal Energy USA Ltd. and Arsenal Energy Holdings; which were incorporated in the USA and Canada respectively. Arsenal's principle place of business is located at Suite 1900, 639 – 5th Avenue SW, Calgary Alberta, Canada, T2P 0M9.

2. Basis of preparation:

(a) Statement of compliance:

These consolidated financial statements have been prepared by management in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

The consolidated financial statements were authorized for issue by the Board of Directors on March 18, 2013.

(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. The methods used to measure fair value are discussed in notes 5 and 13.

(c) Functional and presentation currency:

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

(d) Use of estimates, judgments and assumptions:

The preparation of financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts regarding assets, liabilities, revenue, and expenses. Actual results may differ from estimated amounts as future confirming events occur.

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 have the most significant effect on the amount recognized in the 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.

ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

2. Basis of preparation (continued):

- Share-based compensation – forfeiture rates and volatility.
- Risk management contracts – expected future oil and natural gas prices and expected volatility in these prices.
- Deferred tax – estimates of reversal of temporary differences, tax rates substantively enacted, and likelihood of assets being realized.
- Determinations of cash generating units (“CGU’s”).

3. Significant accounting policies:

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements, and have been applied consistently by the Company and its subsidiaries. Certain comparative amounts have been reclassified to conform with the current year’s presentation.

(a) Basis of consolidation:

- (i) Subsidiaries are entities controlled by the Company. Control exists when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that currently are exercisable are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.
- (ii) Jointly controlled operations and jointly controlled assets:
Many of the Company’s oil and natural gas activities involve jointly controlled assets. The consolidated financial statements include the Company’s share of these jointly controlled assets and a proportionate share of the relevant revenue and related costs.
- (iii) Transactions eliminated on consolidation:
Intercompany balances and transactions, and any unrealized income and expenses arising from intercompany transactions, are eliminated in preparing the consolidated financial statements.

(b) Foreign currency:

- (i) Transactions in foreign currencies are generally translated to Canadian dollars at the average exchange rate for the period. Monetary assets and liabilities denominated in foreign currencies are translated to Canadian dollars at the period end exchange rate. Foreign currency differences arising on translation are recognized in earnings in the period in which they arise.
- (ii) Assets and liabilities of Arsenal’s U.S. operations are translated into Canadian dollars at period end exchange rates while revenues and expenses are translated using average rates for the period. Gains and losses from the translation are deferred and included in accumulated other comprehensive income (“AOCI”).

(c) Financial instruments:

- (i) Non-derivative financial instruments:
Non-derivative financial instruments comprise account receivable, cash and cash equivalents, bank loans, and accounts payables and accrued liabilities. Non-derivative financial instruments are recognized initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs. Subsequent to initial recognition non-derivative financial instruments are measured as described below.

ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

3. Significant accounting policies (continued):

Cash and cash equivalents comprise cash on hand, term deposits held with banks, other short-term highly liquid investments with original maturities of three months or less.

Financial assets at fair value through profit or loss:

An instrument is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Financial instruments are designated at fair value through profit or loss if the Company manages such investments and makes purchase and sale decisions based on their fair value in accordance with the Company's risk management or investment strategy. Upon initial recognition attributable transaction costs are recognized in profit or loss when incurred. Financial instruments are measured at fair value and changes therein are recognized in profit or loss.

Other non-derivative financial instruments, such as cash and cash equivalents, accounts receivable, bank loans, accounts payables and accrued liabilities, are measured at amortized cost using the effective interest method, less any impairment losses.

(ii) Derivative financial instruments:

The Company has entered into certain financial derivative contracts in order to manage the exposure to market risks from fluctuations in commodity prices. These instruments are not used for trading or speculative purposes. The Company has not designated its financial derivative contracts as effective accounting hedges, and thus not applied hedge accounting, even though the Company considers all commodity contracts to be economic hedges. As a result, all financial derivative contracts are classified as fair value through profit or loss and are recorded on the balance sheet at fair value. Transaction costs are recognized in earnings when incurred.

The Company accounts for any forward physical delivery sales contracts, which are entered into and continue to be held for the purpose of receipt or delivery of non-financial items in accordance with its expected purchase, sale or usage requirements as executory contracts. As such, these contracts are not considered to be derivative financial instruments and are not recorded at fair value on the balance sheet. Settlements on these physical sales contracts are recognized in oil and natural gas revenue.

Embedded derivatives are separated from the host contract and are accounted for separately if the economic characteristics and risks of the host contract and the embedded derivative are not closely related, a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and the combined instrument is not measured at fair value through profit or loss. Changes in the fair value of separable embedded derivatives are recognized immediately in earnings.

(iii) Share capital:

Common shares are classified as equity. Incremental costs directly attributable to the issue of common shares and share options are recognized as a deduction from equity, net of any deferred taxes.

(d) Property, plant and equipment and intangible exploration assets:

(i) Recognition and measurement:

Exploration and evaluation expenditures:

ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

3. Significant accounting policies (continued):

Pre-license costs, dry holes, seismic and lease rentals are recognized in the statement of operations as incurred.

Exploration and evaluation costs are capitalized as exploration and evaluation assets according to the expenditure.

Exploration and evaluation assets are assessed for impairment if (i) sufficient data exists to determine technical feasibility and commercial viability, and (ii) facts and circumstances suggest that the carrying amount exceeds the recoverable amount. For purposes of impairment testing, exploration and evaluation assets are allocated to cash-generating units.

The technical feasibility and commercial viability is considered to be determinable when proved and or probable reserves are determined to exist. A review is carried out, at least annually, to ascertain whether proved and or probable reserves have been discovered. Upon determination of proved and or probable reserves, exploration and evaluation assets attributable to those reserves are first tested for impairment and then reclassified from exploration and evaluation assets to a separate category within tangible assets referred to as property, plant and equipment.

Development and production costs:

Items of property, plant and equipment, which include oil and gas development and production assets, are measured at cost less accumulated depletion and depreciation and accumulated impairment. Development and production assets are grouped into Cash Generating Units ("CGU's") for impairment testing. When significant parts of an item of property, plant and equipment, including oil and natural gas interests, have different useful lives, they are accounted for as separate items (major components).

Gains and losses on disposal of an item of property, plant and equipment, including oil and natural gas interests, are determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment and are recognized in profit or loss.

(ii) Subsequent costs:

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of property, plant and equipment are recognized as oil and natural gas interests only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures are recognized in earnings as incurred. Such capitalized oil and natural gas interests generally represent costs incurred in developing proved and/or probable reserves and bringing in or enhancing production from such reserves, and are accumulated on a field or geotechnical area basis. The carrying amount of any replaced or sold component is derecognized. The costs of the periodic servicing of property, plant and equipment are recognized in earnings as incurred.

(iii) Depletion and depreciation:

The net carrying value of development or production assets is depleted using the unit of production method by reference to the ratio of production in the period to the related proved and probable reserves, taking into account estimated future development and decommissioning costs necessary to bring those reserves into production. Future development and decommissioning costs are estimated taking into account the level of development required to produce the reserves. These estimates are reviewed by independent reserve engineers at least annually.

Proved and probable reserves are estimated using independent reserve engineer reports, in accordance with Canadian Securities Regulation National Instrument 51-101,

ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

3. Significant accounting policies (continued):

and represent the estimated quantities of crude oil, natural gas and natural gas liquids which geological, geophysical and engineering data demonstrate with a specified degree of certainty to be recoverable in future years from known reservoirs and which are considered commercially producible.

For depletion purposes, relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

The estimated useful lives for certain production assets for the current and comparative years are as follows:

Pipeline facilities	Unit of production
Turnaround and work over costs	Expensed as incurred

For other assets, depreciation is recognized in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property, plant and equipment.

Leased assets are depreciated over the shorter of the lease term and their useful lives unless it is reasonably certain that the Company will obtain ownership by the end of the lease term. Land is not depreciated.

The estimated useful lives for other assets for the current and comparative years are as follows:

Office equipment	5 years
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Depreciation methods, useful lives and residual values are reviewed at each reporting date.

(e) Leased assets:

Leases where the Company assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

Minimum lease payments made under finance leases are apportioned between the finance expenses and the reduction of the outstanding liability. The finance expenses are allocated to each year during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

Other leases are operating leases, which are not recognized on the Company's statement of financial position.

Payments made under operating leases are recognized in earnings on a straight-line basis over the term of the lease. Lease incentives received are recognized as an integral part of the total lease expense, over the term of the lease.

(f) Business combinations:

The acquisition method of accounting is used to account for acquisitions of subsidiaries and assets that meet the definition of a business under IFRS. The cost of an acquisition is

ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

3. Significant accounting policies (continued):

measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange. The recognized amount of identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured mostly at fair value at the acquisition date. The excess of the cost of acquisition over the recognized amount of identifiable assets, liabilities and contingent liabilities acquired is recorded as goodwill. If the cost of acquisition is less than the recognized amount of the net assets of the subsidiary acquired, the difference is recognized immediately in earnings.

(g) Inventory:

Crude oil inventory consists of amounts produced and in storage tanks or in transit, and is recorded at the lower of the average cost of production and estimated net realizable value. Net realizable value is the estimated selling price in the normal course of business less applicable selling expenses.

(h) Impairment:

(i) Financial assets:

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at its net book value is calculated as the difference between its carrying amount and the present value of the estimated future cash flows discounted at the effective interest rate.

Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.

All impairment losses are recognized in earnings.

An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized. For financial assets measured at amortized cost the reversal is recognized in earnings.

(ii) Non-financial assets:

The carrying amounts of the Company's non-financial assets net of decommissioning obligations, other than E&E assets and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. E&E assets are assessed for impairment when they are reclassified to property, plant and equipment, as oil and natural gas interests, and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For the purpose of impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets. The recoverable amount of an asset or a CGU is the greater of its value in use and its fair value less costs to sell.

In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Value in use is generally computed by reference to the present value of the future cash flows expected to be

ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

3. Significant accounting policies (continued):

derived from production of proved and probable reserves. Management does not expect a significant difference between value in use and fair value less cost to sell.

E&E assets are allocated to related CGU's when they are assessed for impairment, both at the time of any triggering facts and circumstances as well as upon their eventual reclassification to property, plant and equipment.

An impairment loss is recognized if the carrying amount of an asset or its CGU net of decommissioning obligations exceeds its estimated recoverable amount. Impairment losses are recognized in earnings.

An impairment loss in respect of property, plant and equipment and E&E assets recognized in prior years are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depletion and depreciation or amortization, if no impairment loss had been recognized.

(i) Share based payments:

The grant date fair value of equity settled options granted to employees is recognized as compensation expense with a corresponding increase in contributed surplus over the vesting period. A forfeiture rate is estimated on the grant date and is adjusted to reflect the actual number of options that vest.

(j) Provisions:

A provision is recognized if, as a result of a past event, the Company has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. Provisions are not recognized for future operating losses.

Decommissioning obligations:

The Company's activities give rise to dismantling, decommissioning and site disturbance remediation activities. A provision is made for the estimated cost of site restoration and capitalized in the relevant asset category.

Decommissioning obligations are measured at the present value of the expected expenditures required to settle the present obligation at the balance sheet date. Subsequent to the initial measurement, the obligation is adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows and discount rate underlying the obligation. The increase in the provision due to the passage of time is recognized as finance expense whereas increases/decreases due to changes in the estimated future cash flows and discount rate are capitalized. Actual costs incurred upon settlement of the decommissioning obligations are charged against the provision to the extent the provision was established.

(k) Revenue:

Revenue from the sale of oil and natural gas is recorded when the significant risks and rewards of ownership of the product is transferred to the buyer which is usually when legal title passes to the external party. This is generally at the time the product enters the pipeline.

Royalty income is recognized as it accrues in accordance with the terms of the overriding royalty agreements.

ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

3. Significant accounting policies (continued):

(l) Finance income and expenses:

Finance expense comprises interest expense on borrowings, accretion of the discount on provisions and transaction costs.

Borrowing costs incurred for the construction of qualifying assets are capitalized during the period of time that is required to complete and prepare the assets for their intended use or sale. All other borrowing costs are recognized in profit or loss using the effective interest method.

Finance income is recognized as it accrues in profit or loss, using the effective interest method.

(m) Income tax:

Income tax expense comprises current and deferred tax. Deferred tax expense is recognized in earnings except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized on the initial recognition of assets or liabilities in a transaction that is not a business combination. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

(n) Per share amounts:

Basic earnings per share is calculated by dividing the profit or loss attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the period. Diluted earnings per share is determined by adjusting the profit or loss attributable to common shareholders and the weighted average number of common shares outstanding for the effects of dilutive instruments such as options granted to employees. The calculation assumes that the proceeds on exercise of options are used to repurchase shares at the current market price.

4. Future accounting policies:

The Company has reviewed the following new and revised accounting pronouncements that have been issued but are not yet effective and determined that the following may have an impact on the Company's financial statements:

ARSENAL ENERGY INC

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For the years ended December 31, 2012 and 2011

4. Future accounting policies (continued):

(a) IFRS-9 Financial Instruments:

The IASB intends to replace IAS 39 Financial Instruments: Recognition and Measurement with IFRS-9 Financial Instruments. IFRS 9 will be published in three phases, of which the first phase has been published.

The new standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has two classification categories: amortized cost and fair value.

The Company intends to adopt IFRS 9 in its financial statements for the annual period beginning on January 1, 2015. The impact of the adoption of IFRS 9 has not yet been determined.

(b) Joint Arrangements, Consolidation and Disclosures

- (i) IFRS-10 Consolidated Financial Statements replaces IAS-27 Consolidation and Separate Financial Statements and SIC -12 Consolidation – Special Purpose Entities. This standard provides a single model to be applied in control analysis for all investees including special purpose entities.
- (ii) IFRS-11 Joint Arrangements replaces IAS 31 Interest in Joint Ventures and SIC 13 Jointly Controlled Entities – Non - Monetary Contributions by Venturers. IFRS 11 divides joint arrangements into two types, joint operations and joint ventures. Under a joint operation, parties have rights to the assets and obligations for the liabilities on the arrangement and account for their shares share of the assets, liabilities, revenues and expenses. Under a joint venture, parties have the rights to the net assets of the arrangement and account for the arrangement as an investment using the equity method.
- (iii) IFRS-12 Disclosures of Interests in Other Entities, combines in a single standard the disclosure requirements for subsidiaries, associates and joint arrangements as well as unconsolidated structured entities.

The above standards are effective for annual periods beginning on or after January 1, 2013 and must be adopted concurrently. The Company is currently assessing the expected impact, if any, that the adoption of these standards will have on its financial statements.

(c) Fair Value Measurement

In May 2011, the IASB issued IFRS-13 Fair Value Measurement, which provides a consistent and less complex definition of fair value, establishes a framework for measuring fair value and sets out disclosure requirements for fair value measurements. This standard defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company intends to adopt IFRS 13 prospectively in its financial statements for the annual period beginning on January 1, 2013. The extent of the impact of adoption of IFRS 13 has not yet been determined.

(d) Presentation of Items of Other Comprehensive Income

In June 2011, the IASB issued an amendment to IAS 1, "*Presentation of Financial Statements*" ("IAS 1") requiring companies to group items presented within OCI based on whether they may be subsequently reclassified to profit or loss. This amendment to IAS 1 was effective for the Company on January 1, 2012 with full retrospective application. The adoption of this amendment did not have a material impact on the Company's financial statements.

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5. 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 fair values. The fair 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 fair 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 payable is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date. At December 31, 2012 and December 31, 2011, 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.

(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 statement of financial position 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).

6. Business acquisition:

On November 15, 2011, the Company acquired certain producing properties in Western Canada for total cash consideration \$39.3 million. The acquisition has been accounted for using the acquisition method with the results of the operations included in the Company's financial and operating results commencing November 15, 2011. The Company incurred \$0.6 million of transaction costs related to the acquisition. The following table presents the purchase price equation based on estimated fair values:

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6. Business acquisition (continued):

(thousands)

Identifiable assets acquired and liabilities assumed:	
Property, plant and equipment	\$ 56,765
Prepaid expenses	676
Trade receivables	400
Inventory	202
Decommissioning obligations	(18,703)
Total	\$ 39,340

The value attributed to the property, plant and equipment acquired was determined in reference to an engineering report prepared by the Company's third party reserve evaluators using proved plus probable reserves discounted at a rate of 12-15%. Accounts receivable are recognized at the contractual amount and are expected to be collected.

The following table presents the estimated impact on the following as if the acquisition had occurred on January 1, 2011 instead of the actual closing of November 15, 2011:

	2011
Oil and natural gas revenue	\$ 82,800
Net income for the year	7,900
Per share - basic and diluted	\$ 0.05

Since the closing date of November 15, 2011, approximately \$3.8 million of revenue and \$1.5 million of income have been included in comprehensive loss for 2011.

7. Exploration and evaluation assets:

(thousands)

Cost or deemed cost	Total
Balance at December 31, 2010	\$ 6,394
Additions	9,364
Transfer to property, plant and equipment	(2,913)
Transfer to exploration and evaluation expenses	(3,745)
Balance at December 31, 2011	9,100
Additions	6,590
Transfer to property, plant and equipment	(4,936)
Balance at December 31, 2012	\$10,754

In 2011 the Company drilled three dry holes, which resulted in \$3.7 million of drilling and completion costs being transferred to exploration and evaluation expenses, no dry holes were drilled in 2012.

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Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

8. Property, plant and equipment:

(thousands)

Cost or deemed cost	Total
Balance at December 31, 2010	\$ 92,472
Additions	30,092
Property acquisitions	38,575
Transfer from exploration and evaluation assets	2,913
Divestitures	(1,218)
Change in decommissioning obligations	(1,216)
Decommissioning obligations acquired and incurred	19,259
Capitalized share-based compensation	297
Capitalized general and administration	644
Changes in translation of foreign operations	1,006
Balance at December 31, 2011	\$ 182,824
Additions	35,376
Transfer from exploration and evaluation assets	4,936
Divestitures	(5,125)
Capitalized share-based compensation	286
Capitalized general and administration	715
Decommissioning obligations acquired and incurred	317
Change in decommissioning obligations	978
Change in translation of foreign operations	(1,094)
Balance at December 31, 2012	\$ 219,213
Accumulated Depreciation	Total
Balance at December 31, 2010	\$ 18,141
Depletion and depreciation expense	13,117
Divestitures	(211)
Impairment	5,500
Changes in translation of foreign operations	82
Balance at December 31, 2011	36,629
Depletion and depreciation expense	24,560
Divestitures	(925)
Impairment	1,950
Change in translation of foreign operations	(140)
Balance at December 31, 2012	\$ 62,074
NBV	Total
Balance, December 31, 2011	\$ 146,195
Balance, December 31, 2012	\$ 157,139

The calculation of depletion for the year ended December 31, 2012 included estimated future development and decommissioning costs of \$127.6 million (December 31, 2011 - \$143.8 million) associated with the development and decommissioning of the Company's proved plus probable reserves and excludes salvage value of \$11.5 million (December 31, 2011 - \$10.5 million).

During 2012, the Company disposed of certain non-core properties for proceeds of \$1.9 million (December 31, 2011 - \$0.6 million), this resulted in a loss of \$622,090 (December 31, 2011 gain of \$31,141).

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Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

9. Impairment loss:

As at December 31, 2012, as a result of depressed gas prices and downward revisions of oil reserves, the Company tested certain natural gas and oil CGU's for impairment. The recoverable amount was determined using value in use, net of decommissioning expenditures, based on discounted cash flows of proved plus probable reserves as estimated by the Company's independent reserve evaluators using forecast prices and costs and discount rates of between 10% and 20%. In determining the appropriate discount rate the Company considered the acquisition metrics of recent transactions completed with assets similar to those in the specific CGU's. As a result of depressed gas prices, during the three months ended March 31, 2012 it was determined that the net book value of certain CGU's exceeded the recoverable amount and an impairment of \$1.95 million (2011 - \$5.5 million) was recognized. No further impairments were recognized as of December 31, 2012.

The following estimates were used in determining whether an impairment to the carrying value of the CGU's existed at December 31, 2012.

Benchmark reference price forecast	2013	2014	2015	2016	2017	2018	2019	2020
WTI (\$US/bbl)	90.00	89.75	91.55	93.40	92.00	93.85	95.70	97.65
Edmonton Par (\$CDN/bbl)	85.00	84.70	89.45	91.20	89.80	91.60	93.40	95.30
Bow River Hardisty (\$CDN/bbl)	67.00	66.70	70.45	71.20	70.80	71.60	73.40	74.30
AECO-C (\$CDN/mcf)	3.20	3.75	4.05	4.35	4.65	5.10	5.40	5.75
Edmonton Butanes (\$CDN/bbl)	72.25	72.00	76.05	77.50	76.35	77.85	79.40	81.00
Edmonton Pentanes (\$CDN/bbl)	89.25	88.95	93.90	95.75	94.30	96.20	98.05	100.05
Exchange rate (\$CDN/\$US)	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

After 2020 the price forecast escalates at 2% per year to the end of the reserve life and the exchange rate remains constant at 1.00.

An increase in the discount rate of 2% would result in an additional impairment charge of \$2.0 million for the year ended December 31, 2012.

10. Bank loan:

In January 2013, the Company, based on additional production and added reserves, requested a further review of the credit facility. In January 2013, the syndicate of bankers increased the facility to \$85 million with all terms and conditions relating to the facility remaining unchanged. The next review date is May 31, 2013.

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 review of the borrowing base. The credit facility is subject to a semiannual borrowing base review based on internally generated engineering.

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Notes to Consolidated Financial Statements

For the years ended December 31, 2012 and 2011

10. Bank loan (continued):

At December 31, 2012, debt under the credit facility amounted to \$62.5 million (December 31, 2011 – \$52.1 million) and includes \$11.0 million (December 31, 2011 – \$5.0 million) of US dollar denominated borrowings.

The Company's credit facility has a financial covenant that, without the written consent of the lenders, 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 December 31, 2012, the Company was in compliance with its working capital covenant.

11. Decommissioning obligations:

<i>(thousands)</i>	Year ended December 31, 2012	Year ended December 31, 2011
Beginning of year	\$ 37,326	\$ 19,667
Obligations settled	(477)	(819)
Obligations acquired	-	18,703
Obligations disposed	(1,629)	(436)
Obligations incurred	317	622
Change in estimates	978	(1,214)
Foreign currency translation	(72)	95
Accretion expense	930	708
End of year	\$ 37,373	\$ 37,326

The Company's decommissioning obligations result from its ownership interest in oil and natural gas assets including well sites, gathering systems and facilities. The total decommissioning obligations are estimated based on the Company's net ownership interest in all wells, pipelines and facilities, estimated costs to reclaim and abandon these wells, pipelines 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 \$37.4 million as at December 31, 2012 (December 31, 2011- \$37.3 million) based on an undiscounted inflation adjusted total future liability of \$51.5 million (December 31, 2011 - \$52.4 million). These payments are expected to be made over the next 25 years with the majority of costs to be incurred between 2013 and 2022. The discount factor, being the risk free rate related to the liability is 2.4% (December 31, 2011 2.8%).

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For the years ended December 31, 2012 and 2011

12. Share capital:

The Company is authorized to issue an unlimited number of common shares with the holders of common shares being entitled to one vote per share.

(a) Issued

<i>(thousands)</i>	Year ended December 31, 2012		Year ended December 31, 2011	
	Number of Shares	Share capital	Number of Shares	Share Capital
Balance, beginning of year	157,282	\$136,860	140,812	\$122,609
Issue of shares	-	-	22,159	21,050
Share issue costs	-	-	-	(1,694)
Transfer of share-based compensation on exercise of options	-	100	-	470
Issued on exercise of options	313	121	1,343	561
Repurchase of shares	(1,647)	(1,435)	(7,032)	(6,136)
Balance, end of year	155,948	\$135,646	157,282	\$136,860

Common shares

On February 15, 2011, the Company issued 22,158,500 common shares at \$0.95 per share for gross proceeds of \$21.1 million.

(b) Share based payments

The Company has a stock option plan under 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, December 31, 2010	12,755	\$0.62
Granted	4,840	0.68
Exercised	(1,343)	0.42
Expirations	(390)	1.09
Forfeited	(1,168)	0.72
Balance, December 31, 2011	14,694	\$0.64
Granted	1,317	0.52
Exercised	(313)	0.39
Forfeited	(404)	0.72
Balance, December 31, 2012	15,294	\$0.64

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12. Share capital (continued):

The following table summarizes information about the stock options outstanding and exercisable at December 31, 2012:

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	\$0.21	1.00	1,278	\$0.21
\$0.36 to \$0.50	3,200	0.43	2.17	2,283	0.40
\$0.51 to \$0.70	5,026	0.63	2.82	2,266	0.62
\$0.71 to \$1.00	5,790	0.86	2.31	3,777	0.85
Total	15,294	\$0.64	2.34	9,604	\$0.60

Options granted to 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:

	Year ended December 31, 2012	Year ended December 31, 2011
Risk free interest rate	1.15 – 1.51%	1.18 – 2.25%
Expected life	4 years	4 years
Expected volatility	82 - 85%	87 - 92%
Expected dividend	nil	nil
Expected forfeitures	5%	5%
Weighted average fair value per share	\$0.32	\$0.44

(c) Loss per share

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

	2012	2011
Basic and diluted:		
Loss per share basic and diluted	\$ (0.00)	\$ (0.02)
Weighted average shares outstanding:		
Basic and diluted	156,395	158,630

In computing diluted loss per share for the year ended December 31, 2012, 15,294,000 (2011-14,693,670) options were excluded from the dilution calculations as they were anti-dilutive.

(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. In 2011 the Company acquired 1,573,000 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.

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12. Share capital (continued):

On June 16, 2011, the Company announced its intention to make a normal course issuer bid ("NCIB") that commenced June 20, 2011 and ended June 19, 2012. In 2011, the Company purchased 5,458,544 common shares at a cost of \$3,519,673 or \$0.65 per share plus expenses. The stated value of these shares exceeded the cost by \$1,243,622 and has been recorded to contributed surplus. In 2012, the Company purchased 1,141,500 additional common shares at a cost of \$768,280 or \$0.67 per share plus expenses. The stated value of these shares exceeded the cost by \$225,900 and has been recorded to contributed surplus.

On July 5, 2012, the Company announced its intention to make a normal course issuer bid ("NCIB") that commenced July 9, 2012 and ends July 8, 2013. A total of 7,809,705 common shares may be acquired under the bid representing 5% of the 156,194,094 common shares outstanding as of July 4, 2012. To December 31, 2012, the Company had purchased 506,500 common shares at a cost of \$272,350 or \$0.54 per share plus expenses. The stated value of these shares exceeded the cost by \$168,329 and has been recorded to contributed surplus.

13. Risk management and financial instruments:

The Company's activities expose it to a variety of financial risks that arise as a result of its exploration, development, production, and financing activities such as:

- market risk;
- credit risk; and
- liquidity risk; and

This note presents information about the Company's exposure to each of the above risks, the Company's objectives, policies and processes for measuring and managing risk, and the Company's management of capital. Further quantitative disclosures are included throughout these financial statements.

The Board of Directors oversees managements' establishment and execution of the Company's risk management framework. Management has implemented and monitors compliance with risk management policies. The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities.

a) Market Risk:

Foreign currency exchange rate risk

Foreign currency exchange rate risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in foreign exchange rates. Canadian commodity prices are influenced by fluctuations in the Canadian to U.S. dollar exchange rate. As at December 31, 2012, the Company does not have any foreign currency exchange contracts in place. A \$0.01 change in the CAD/US dollar exchange rate is estimated to result in a change to the 2012 net loss by \$141,763.

Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its bank loan which bears a floating rate of interest. Average bank debt outstanding during the year ended December 31, 2012 was \$57.4 million (2011 - \$11.1 million). For the year ended December 31, 2012, a 1.0 percent change to the effective interest rate would have a \$574,000 impact on net loss (2011 - \$111,000).

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Notes to Consolidated Financial Statements

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13. Risk management and financial instruments (continued):

For the year ended December 31, 2012, the Company has attempted to mitigate the impact of future fluctuations in interest rates on its outstanding debt by entering into a swap contract fixing the base interest rate on \$20 million of banker's acceptance borrowings as outlined below. These rates are, under the Company's credit facility, subject to additional stamping fees from 2.00% to 3.50% depending on the debt to cash flow ratio, as defined, and as calculated at the Company's most recent quarter end. For the year ended December 31, 2012, the Company recorded a realized interest rate loss of \$45,531 and an unrealized interest rate loss of \$38,012.

(thousands of \$Cdn.)

Subject of Contract	Remaining Term	Notional Quantity	Reference	Strike Price	Fair value
30 day BA rate	Jan 1, 2013 - Feb 13, 2015	\$20,000	CAD-BA-CDOR	1.50%	(\$38)

Commodity price risk

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 December 31, 2012, the Company had seven crude oil swaps in-place fixing the price of future production for a specific period of time. Five on the contracts are with ATB Financial and two are with the National Bank of Canada. Five of the risk management contracts are denominated in Canadian dollars and two are denominated in U.S. dollars. For the year ended December 31, 2012, the Company recorded a realized commodity contract gain of \$0.1 million (December 31, 2011 - \$3.4 million gain) and an unrealized commodity contract gain of \$4.0 million (December 31, 2011 - \$2.4 million loss).

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

(thousands \$Cdn.)	As at December 31	
	2012	2011
Total fair value consists of the following:		
Fair value, end of year - current portion	\$721	(\$2,291)
Fair value, end of year - long-term portion	(465)	(1,485)
Total fair value, end of year	\$256	(\$3,776)

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

(thousands \$Cdn.)	Years ended December 31	
	2012	2011
Fair value, beginning of year	(\$3,776)	(\$1,421)
Changes in fair value	4,170	1,002
Settlement paid (received)	(138)	(3,357)
Fair value, end of year	\$256	(\$3,776)

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For the years ended December 31, 2012 and 2011

13. Risk management and financial instruments (continued):

The Company had the following risk management contracts outstanding as at December 31, 2012.

(thousands \$Cdn.)				
Commodity Sold	Volume Sold	Remaining Term	Pricing	Fair Value \$ Cdn
Oil	300 bbl per day	Jan 1, 2013 - Dec 31, 2013	\$92.10 per bbl	(\$122)
Oil	400 bbl per day	Jan 1, 2013 - Dec 31, 2013	\$92.10 per bbl	(162)
Oil	300 bbl per day	Jan 1, 2013 - Dec 31, 2013	\$101.00 per bbl	846
Oil	300 bbl per day	Jan 1, 2013 - Dec 31, 2013	\$95.00 per bbl	194
Oil	300 bbl per day	Jan 1, 2014 - Dec 31, 2014	\$92.75 per bbl	(35)
Oil	300 bbl per day	Jan 1, 2014 - Dec 31, 2014	\$90.00 USD per bbl	(231)
Oil	300 bbl per day	Jan 1, 2014 - Dec 31, 2014	\$90.00 USD per bbl	(234)
				\$ 256

On January 14, 2013, the Company entered into a crude oil commodity price contract to sell 200 barrels of production per day from January 1, 2014 until December 31, 2014 at a price of \$92.00 USD per barrel.

On January 30, 2013, the Company entered into a crude oil commodity price contract to sell 200 barrels of production per day from February 1, 2013 until December 31, 2013 at a price of \$98.10 Cdn per barrel.

On February 21, 2013, the Company entered into a crude oil commodity price contract to sell 200 barrels of production per day from January 1, 2014 until December 31, 2014 at a price of \$93.80 Cdn per barrel.

Commodity price sensitivity:

Commodity Price	
Oil production sold under risk management contract (barrels)	803,000
Price Change (Cdn. per bbl)	\$ 1.00
Sensitivity - change before income tax	\$ 803,000

b) Fair value of financial instruments:

The Company's exposure under its financial instruments is limited to financial assets and liabilities, all of which are included in these financial statements. Financial instruments include cash and cash equivalents, 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.

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Notes to Consolidated Financial Statements

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13. Risk management and financial instruments (continued):

- 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. The maximum exposure to credit risk at year end is as follows:

	December 31, 2012	December 31, 2011
Accounts receivable	\$10,610	\$11,677

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

As at December 31, 2012 the Company's receivables consisted of \$3.1 million (2011 - \$3.1 million) from joint interest partners the majority of which has either been collected or is expected to be collected within the next 60 days, \$7.3 million (2011 - \$8.1 million) of receivables from petroleum and natural gas marketers, which have been collected and \$0.2 million (2011 - \$0.5 million) of other receivables. At December 31, 2012, Arsenal had approximately \$0.4 million (2011 - \$0.8 million) of receivables that are considered past due and collection efforts, including the taking of production and consideration of legal action have commenced.

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production in Canada and the 20th day in the U.S.. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint interest receivables are typically collected within one to three months of the joint interest bill being issued to the partner. The Company attempts to mitigate the risk from joint interest receivables by obtaining partner approval of significant capital expenditures and payment of cash advances prior to expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances are dependent on industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition, further risk exists with joint interest partners as disagreements occasionally arise that increase the potential for non-collection. The Company does not typically obtain collateral from petroleum and natural gas marketers or joint interest partners; however the Company does have the ability to request deposits and to withhold production from joint interest partners in the event of non-payment.

d) Liquidity risk:

Liquidity risk is the risk that the Company will encounter difficulty in meeting obligations associated with the financial liabilities. The Company's financial liabilities consist of accounts payable, financial instruments and the bank loan. Accounts payable consists of invoices payable to trade suppliers for office, field operating activities and capital expenditures. The

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13. Risk management and financial instruments (continued):

Company processes invoices within a normal payment period. The Company maintains a revolving credit facility, as outlined in note 10, that is based on proved and producing reserves and is subject to renewal annually by the lenders. The Company also maintains and monitors a certain level of cash flow which is used to partially finance all operating and capital expenditures as the Company does not pay dividends.

14. Capital management:

In order to continue the Company's ongoing exploration and development program, the Company needs to be conscious of and work towards maintaining 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, Canadian crude differentials, interest rates and foreign exchange rates. It then determines increases or decreases to its capital budget and what, if any, additional initiatives may need to be implemented.

The Company considers shareholders' equity, its line of credit facility debt 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 a portion of the Company's debt and production, by closely monitoring expenses, by accurately estimating capital expenditures on projects, by closely monitoring and scrutinizing the results of its capital expenditure program and by scheduling 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, transaction costs and seismic 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 operational items. The Company's goal is to target this ratio at 1.50:1 but the ratio can and will fluctuate based on the timing of property transactions, commodity prices and on the level of exploratory and development drilling activity particularly in the US. 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 and any other instance when the ratio is not within the target range 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, at least quarterly, when actual results are realized and compared to budget and when critical factors change. 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.

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14. Capital management (continued):

At December 31, 2012, the Company's net debt to annualized funds flow (Q4 2012 funds from operations annualized) ratio was 1.71:1 and its debt to equity ratio was 1.24:1. The debt to annualized funds flow ratio at December 31, 2012 was higher than the targeted range as a result of capital spent on drilling and completing Bakken wells in North Dakota and the drilling of two wells at Princess, Alberta. The first Princess well drilled did not commence production until September 2012 and the second one was only production tested and therefore the quarter cash flow does not fully reflect full quarter production from these two wells. In addition, during 2012, the crude differentials in both Canada and the US had increased due to excess crude supply and limited take away capacity further reducing expected cash flow.

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

<i>(thousands)</i>	December 31, 2012	December 31, 2011
Cash and cash equivalents	\$ -	\$ 626
Accounts receivable, prepaids and inventory	11,922	13,138
Accounts payable and accrued liabilities	(17,966)	(17,453)
Working capital deficiency	\$ (6,045)	\$ (3,689)
Bank loan	(62,447)	(52,062)
Net debt	\$(68,492)	\$(55,751)
Annualized funds flow ^{1,2}	\$ 39,999	\$ 33,762
Net debt to annualized funds flow ratio	1.71	1.65
Shareholders' equity	\$ 55,027	\$ 54,873
Debt to equity	1.24	1.02

15. Income tax expense:

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

<i>(thousands)</i>	2012	2011
Income before income tax	\$ 3,671	\$ 539
Combined federal and provincial tax rate	25.0%	26.56%
Expected tax provision	918	143
Increase (decrease) in taxes resulting from:		
Share-based compensation	270	373
Change in tax rates	15	33
Tax impact of foreign jurisdictions	1,294	1,186
Flow through shares	-	717
Other	(111)	433
Unrecognized deferred tax asset	1,398	199
	\$3,784	\$3,084

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15. Income tax expense (continued):

The components of the deferred income tax asset and liability are as follows:

<i>(thousands)</i>	2012	
	Canadian Operations	US Operations
Deferred tax assets:		
Decommissioning obligation	\$ 8,228	\$ 1,153
Non-capital losses	-	8,142
Deferred tax liabilities:		
Property, plant and equipment	(5,605)	(18,416)
Other	(848)	(23)
	\$ 1,775	\$ (9,144)
<i>(thousands)</i>	2011	
	Canadian Operations	US Operations
Deferred tax assets:		
Decommissioning obligation	\$ 8,544	\$ 1,300
Non-capital losses	2,332	4,875
Deferred tax liabilities:		
Property, plant and equipment	(8,320)	(11,652)
Other	(781)	(19)
	\$ 1,775	\$ (5,496)

Based on an independent reserve report prepared by an independent third party, the Company has determined that it is probable that future taxable profits will be available against which the temporary differences can be utilized in the amount of \$1.8 million.

The Company's assets have a tax basis of \$137.1 million at December 31, 2012 (December 31, 2011 - \$125.6 million) available for deduction against future taxable income. The non-capital loss carry forwards in Canada of \$14.4 million (December 31, 2011 - \$14.7 million) expire between 2023 and 2028. The following table summarizes the tax pools:

<i>(thousands)</i>	December 31, 2012	
	Canada	US
Cumulative Canadian Oil and Gas Property Expense	\$ 31,894	\$ -
Cumulative Canadian Development Expense	11,210	-
Cumulative Canadian Exploration Expense	14,576	-
Undepreciated Capital Cost	28,971	9,946
Share Issue Costs	1,767	-
Non-capital Losses	14,356	20,793
Capital Losses and Other	3,581	-
Balance, end of period	\$106,355	\$30,739

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15. Income tax expense (continued):

The following table summarizes the unrecognized temporary differences for which no tax asset has been recorded:

<i>(thousands)</i>	2012	2011
Non-capital losses	\$ 14,356	\$ 5,343
Risk management contracts	-	4,002
Share issue costs	1,767	2,626
Capital losses	3,581	3,565
Other	347	373
	\$ 20,051	\$ 15,909

The following tables provide a continuity of the deferred income tax asset (liability):

<i>(thousands)</i>	December 31, 2010	Recognized in profit and loss	Recognized in equity and other	December 31, 2011
Decommissioning obligation	\$5,585	\$ 4,260	\$ -	\$ 9,844
Risk management contracts	173	(173)	-	-
Non-capital losses	3,928	3,279	-	7,207
Property, plant and equipment	(8,745)	(10,434)	(793)	(19,972)
Other	(639)	(16)	(145)	(800)
	\$ 302	\$(3,084)	\$ (938)	\$ (3,721)

<i>(thousands)</i>	December 31, 2011	Recognized in profit and loss	Recognized in equity and other	December 31, 2012
Decommissioning obligation	\$ 9,844	\$ (463)	\$ -	\$ 9,381
Non-capital losses	7,207	935	-	8,142
Property, plant and equipment	(19,972)	(4,049)	-	(24,021)
Other	(800)	(207)	136	(871)
	\$ (3,721)	\$(3,784)	\$136	\$ (7,369)

16. Supplemental cash flow information:

Year ended December 31 <i>(thousands)</i>	2012	2011
Change in non-cash working capital items:		
Accounts receivable	\$ 1,067	\$ (3,578)
Prepaid expenses and deposits	174	(580)
Inventory	(17)	(274)
Accounts payable and accrued liabilities	514	132
	1,738	(4,300)
Amounts relating to operating activities	1,088	(1,598)
Amounts relating to financing activities	542	(126)
Amounts relating to investing activities	108	(2,576)
	1,738	(4,300)
Taxes Paid	\$ -	\$ 6
Interest paid	\$ 1,980	\$ 412

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17. 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.

December 31, 2012 (\$Cdn.) (thousands)	Canada	U.S.	Total
Oil and gas revenue	46,963	35,205	82,168
Income (loss) before income taxes	(5,961)	9,633	3,672
Operating income ¹	16,279	21,195	37,474
Exploration and evaluation assets	10,754	-	10,754
Property, plant and equipment	99,109	58,030	157,139
Capital expenditures	6,485	29,606	36,091
Exploration and evaluation expenditures	6,590	-	6,590
Depletion and depreciation	15,756	8,796	24,552
Interest and other financing charges	1,003	1,279	2,282
Property acquisitions	-	-	-
Property dispositions	(1,928)	-	(1,928)

December 31, 2011 (\$Cdn.) (thousands)	Canada	U.S.	Total
Oil and gas revenue	34,116	24,350	58,466
Income (loss) before income taxes	(9,564)	10,103	539
Operating income ¹	16,722	14,140	30,862
Exploration and evaluation assets	9,100	-	9,100
Property, plant and equipment	108,387	37,808	146,195
Capital expenditures	7,392	23,715	31,107
Exploration and evaluation expenditures	9,364	-	9,364
Depletion and depreciation	9,692	3,302	12,894
Interest and other financing charges	354	580	934
Property acquisitions	38,575	-	38,575
Property dispositions	(622)	-	(622)

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

18. Commitments and contingencies:

a) Office premises, equipment leases and firm service transportation:

The Company leases its office premises, computer equipment and field vehicles through operating leases for accounting purposes. As a result of the property acquisition in 2011 the Company assumed a firm service transportation commitment for its gas production.

The total estimated operating lease commitments and firm service transportation commitments are as follows:

2013	\$ 843
2014	797
2015	749
2016	694
Thereafter	318
Total commitment	\$ 3,401

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18. Commitments and contingencies (continued):

b) 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 earnings in the year of resolution.

19. Personnel expenses:

The aggregate payroll expense of employees and executive management was as follows:

<i>(thousands)</i>	2012	2011
Salaries, wages and benefits	\$ 3,800	\$ 3,180
Director fees	68	63
Share based payments (i)	1,079	1,405
Total employee remuneration	4,947	4,648
Capitalized portion of total remuneration	714	942
	\$ 5,661	\$ 5,589

Personnel expenses directly attributed to capital activities have been capitalized and included in property, plant and equipment and intangible exploration assets.

The Company has determined that the key management personnel consist of its officers and directors. Key management personnel compensation is comprised of the following:

<i>(thousands)</i>	2012	2011
Salaries, wages and benefits	\$ 1,576	\$ 1,315
Director fees	68	63
Termination benefits	1,611	1,086
Share-based payments (i)	733	957
	\$ 3,988	\$ 3,421

(i) Represents the amortization of share based compensation associated with options granted to executive officers as recorded in the financial statements.

20. Subsequent event:

On March 13, 2013, the Company completed a private placement and issued 2,604,166 at \$0.48 per share for gross proceeds of \$1.25 million.