

Consolidated Financial Statements of

**ARSENAL ENERGY INC.**

Years ended December 31, 2011 and 2010

## 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 21, 2012

# 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, 2011, December 31, 2010 and January 1, 2010, the consolidated statements of loss, comprehensive loss, changes in shareholders' equity and cash flows for the years ended December 31, 2011 and December 31, 2010, 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, 2011, December 31, 2010 and January 1, 2010, and its consolidated financial performance and its consolidated cash flows for the years ended December 31, 2011 and December 31, 2010 in accordance with International Financial Reporting Standards.

Signed "KPMG LLP"

Chartered Accountants  
Calgary, Canada  
March 21, 2012

# Arsenal Energy Inc.

## Consolidated Statements of Financial Position

	December 31, 2011	December 31, 2010 (note 22)	January 1, 2010 (note 22)
<b>Assets</b>			
Current assets:			
Cash and cash equivalents	\$ 625,541	\$ 1,448,009	\$ 1,325,915
Accounts receivable (note 14)	11,677,448	8,099,902	6,470,045
Inventory	482,136	-	-
Prepaid expenses and deposits	978,354	398,009	532,808
Risk management contracts (note 14)	-	-	126,749
	13,763,479	9,945,920	8,455,517
Reclamation deposit	152,550	149,190	157,650
Exploration and evaluation assets (note 8)	9,100,169	6,394,505	-
Property, plant and equipment (notes 9)	146,194,342	74,331,026	77,989,725
Deferred taxes (notes 16)	1,775,276	1,775,276	1,775,276
	\$ 170,985,816	\$92,595,917	\$88,378,168
<b>Liabilities</b>			
Current liabilities			
Accounts payable and accrued liabilities	\$ 17,452,738	\$17,320,820	\$14,778,189
Bank loan (note 11)	-	11,412,875	22,290,000
Risk management contracts (note 14)	2,291,080	993,344	-
	19,743,818	29,727,039	37,068,189
Bank loan (note 11)	52,062,272	-	-
Flow through share premium	-	792,968	346,492
Risk management contracts (note 14)	1,484,526	427,169	123,371
Deferred taxes (notes 16)	5,496,305	1,473,676	-
Decommissioning obligations (note 12)	37,325,946	19,667,331	21,182,129
	116,112,867	52,088,183	58,720,181
<b>Shareholders' Equity</b>			
Common shares (note 13(a))	136,859,986	122,609,238	106,471,683
Contributed surplus	9,986,602	7,374,054	6,170,547
Accumulated other comprehensive loss	(152,863)	(199,996)	-
Deficit	(91,820,776)	(89,275,562)	(82,984,243)
	54,872,949	40,507,734	29,657,987
	\$ 170,985,816	\$92,595,917	\$88,378,168

Segmented information (note 19)

Commitments and contingencies (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, 2011 and 2010

	2011	2010
		(note 22)
<b>Revenue</b>		
Oil and gas	\$ 58,465,937	\$ 43,665,720
Royalties	(11,777,485)	(7,826,810)
	46,688,452	35,838,910
Realized gain on risk management contracts (note 14(a))	3,356,993	1,788,624
Unrealized loss on risk management contracts (note 14(a))	(2,355,109)	(1,423,891)
	47,690,336	36,203,643
<b>Expenses</b>		
Operating and transportation	15,826,747	15,284,387
General and administrative	3,971,847	3,566,617
Exploration and evaluation (note 8)	5,663,250	2,250,984
Property, plant and equipment impairment (note 10)	5,500,000	5,948,300
Depletion and depreciation	12,893,856	12,843,385
Share-based compensation	1,405,166	1,050,827
Gain on sale of property (note 9)	(31,141)	(1,282,406)
	45,229,725	39,662,094
Income (loss) from operations	2,460,611	(3,458,451)
Financial items		
Interest and other financing charges (note 18)	933,990	1,019,755
Accretion (note 12 and 18)	708,499	756,042
Transaction costs (note 18)	613,611	-
Foreign exchange gain	(334,489)	(13,828)
	1,921,611	1,761,969
Income (loss) before income tax	539,000	(5,220,420)
Deferred tax expense (note 16)	(3,084,214)	(1,070,899)
Net loss for the year	\$ (2,545,214)	\$ (6,291,319)
Loss per share (note 13 (c))		
Basic and diluted	\$ (0.02)	\$ (0.05)

## Consolidated Statements of Comprehensive Loss

	2011	2010
Net loss for the year	\$ (2,545,214)	\$ (6,291,319)
Translation gain (loss) on foreign operations	47,133	(199,996)
Comprehensive loss	\$ (2,498,081)	\$ (6,491,315)

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

# Arsenal Energy Inc.

## Consolidated Statements of Changes in Shareholders' Equity

	Number of Shares	Share capital	Contributed surplus	Accumulated other comprehensive loss	Deficit	Total Shareholders' equity
Balance January 1, 2011 (note 22)	140,812,472	\$122,609,238	\$7,374,054	\$(199,996)	\$(89,275,562)	\$40,507,734
Net loss for the year	-	-	-	-	(2,545,214)	(2,545,214)
Issue of shares (note 13 (a))	22,158,500	21,050,575	-	-	-	21,050,575
Share issue costs (note 13 (a))	-	(1,694,307)	-	-	-	(1,694,307)
Share-based compensation expensed	-	-	1,405,165	-	-	1,405,165
Share-based compensation capitalized	-	-	297,480	-	-	297,480
Transfer of share-based compensation on exercise of options (note 13 (a))	-	469,834	(469,834)	-	-	-
Issued on exercise of options (note 13 (a))	1,342,833	560,807	-	-	-	560,807
Repurchase of shares (note 13 (a))	(7,031,544)	(6,136,161)	1,379,737	-	-	(4,756,424)
Translation gain on foreign operations	-	-	-	47,133	-	47,133
<b>Balance December 31, 2011</b>	<b>157,282,261</b>	<b>\$136,859,986</b>	<b>\$9,986,602</b>	<b>\$(152,863)</b>	<b>\$(91,820,776)</b>	<b>\$54,872,949</b>

	Number of Shares	Share capital	Contributed surplus	Accumulated other comprehensive loss	Deficit	Total Shareholders' equity
Balance January 1, 2010 (note 22)	120,461,890	\$106,471,683	\$6,170,547	\$ -	\$(82,984,243)	\$29,657,987
Net loss for the year	-	-	-	-	(6,291,319)	(6,291,319)
Issue of shares (note 13 (a))	21,583,000	18,315,650	-	-	-	18,315,650
Share issue costs (note 13 (a))	-	(1,161,279)	-	-	-	(1,161,279)
Share-based compensation expensed	-	-	1,050,827	-	-	1,050,827
Share-based compensation capitalized	-	-	211,130	-	-	211,130
Transfer of share-based compensation on exercise of options (note 13 (a))	-	65,318	(65,318)	-	-	-
Issued on exercise of options (note 13 (a))	171,500	79,150	-	-	-	79,150
Repurchase of shares (note 13 (a))	(1,403,918)	(1,161,284)	6,868	-	-	(1,154,416)
Translation loss on foreign operations	-	-	-	(199,996)	-	(199,996)
<b>Balance December 31, 2010</b>	<b>140,812,472</b>	<b>\$122,609,238</b>	<b>\$7,374,054</b>	<b>\$(199,996)</b>	<b>\$(89,275,562)</b>	<b>\$40,507,734</b>

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, 2011 and 2010

	Year ended December 31	
	2011	2010 (note 22)
<b>Operating Activities:</b>		
Net loss for the period	\$ (2,545,214)	\$ (6,291,319)
Items not affecting cash:		
Non-cash general and administrative expense	-	63,375
Unrealized loss on risk management contracts	2,355,109	1,423,891
Depletion and depreciation	12,893,856	12,843,385
Accretion	708,499	756,042
Transaction costs (note 7)	613,611	-
Deferred tax expense	3,084,214	1,070,899
Property, plant and equipment impairment	5,500,000	5,948,300
Share-based compensation	1,405,166	1,050,828
Unrealized foreign exchange (gain) loss	(373,458)	38,511
Gain on sale of property and equipment	(31,141)	(1,282,406)
Exploration and evaluation expense	4,108,120	587,947
Decommissioning obligations settled (note 12)	(819,283)	(1,083,838)
	26,899,479	15,125,615
Net change in non-cash working capital (note 17)	(1,598,245)	(4,042,961)
Net cash from operating activities	25,301,234	11,082,654
<b>Financing Activities:</b>		
Bank loan advances (repayments)	40,564,619	(10,603,715)
Issue of shares for cash	21,050,575	19,598,550
Issue of shares on exercise of stock options	560,807	79,150
Repurchase of shares	(4,756,424)	(1,154,417)
Share issue costs	(1,694,304)	(1,518,404)
Net change in non-cash working capital items (note 17)	(126,304)	56,839
Net cash from financing activities	55,598,969	6,458,003
<b>Investing Activities:</b>		
Property, plant and equipment	(31,107,154)	(14,927,652)
Exploration and evaluation expenditures	(9,363,845)	(11,028,488)
Property acquisition	(38,574,702)	(2,259,529)
Transaction costs	(613,611)	-
Disposition of property, plant and equipment	621,914	5,919,077
Net change in non-cash working capital items (note 17)	(2,575,600)	5,033,695
Net cash (used in) investing activities	(81,612,998)	(17,262,897)
Foreign exchange loss on cash held in foreign currency	(109,673)	(155,666)
Change in cash and cash equivalents during the year	(822,468)	122,094
Cash and cash equivalents, beginning of year	1,448,009	1,325,915
Cash and cash equivalents, end of year	\$ 625,541	\$ 1,448,009

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, 2011 and 2010

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## 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 and Williston basin in Canada and the United States. The consolidated financial statements of the Company as at and for the years ended December 31, 2011 and 2010 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 – 5<sup>th</sup> Avenue SW, Calgary Alberta, Canada, T2P 0M9.

## 2. Basis of preparation:

### (a) Statement of compliance:

These financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board. A summary of the significant accounting policies and method of computation is presented in note 3 to the financial statements. These policies have been retrospectively and consistently applied except where specific exemptions permitted an alternative treatment on transition to IFRS in accordance with IFRS 1 – First-time adoption of International Financial Reporting Standards (“IFRS-1”). 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 22 and includes reconciliations of equity and net loss for comparative periods from former Canadian GAAP (“previous GAAP”) to IFRS.

The consolidated financial statements were authorized for issue by the Board of Directors on March 21, 2012.

### (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 14.

### (c) Functional and presentation currency:

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

### (d) Use of estimates and judgments:

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.

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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## 2. Basis of preparation (continued):

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.
- 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.

## 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 net income 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").

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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## 3. Significant accounting policies (continued):

### (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.

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:

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 profit or loss 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 profit or loss.

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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### 3. Significant accounting policies (continued):

(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:

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. The Company allocated its historical property, plant and equipment at January 1, 2010, the date of transition to IFRS, to the CGU's, based on a proration using December 31, 2009 externally determined proved and probable reserve volumes underlying each of the CGU's. 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 profit or loss 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

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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### 3. Significant accounting policies (continued):

derecognized. The costs of the periodic servicing of property, plant and equipment are recognized in profit or loss 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, 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:

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

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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:

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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.

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Notes to Consolidated Financial Statements

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### 3. Significant accounting policies (continued):

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 profit or loss 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 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 the income statement.

#### (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 profit or loss.

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 profit or loss.

##### (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

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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### 3. Significant accounting policies (continued):

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 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 profit or loss.

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. 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

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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### 3. Significant accounting policies (continued):

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.

#### (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 profit or loss 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

# ARSENAL ENERGY INC

## Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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### 3. Significant accounting policies (continued):

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.

#### (o) Flow-through shares:

The resource expenditure deductions for income tax purposes related to exploration and development activities funded by flow-through share arrangements are renounced to investors in accordance with tax legislation. On issuance the premium received on the flow-through shares, being the difference in price over a common share with no tax attributes is recognized on the statement of financial position. As expenditures are incurred the deferred tax liability associated with the renounced tax deductions are recognized through profit and loss along with a pro-rata portion of the deferred premium.

### 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:

#### (a) IFRS-9 Financial Instruments:

As of January 1, 2015, the Company will be required to adopt IFRS-9 Financial Instruments, which is the result of the first phase of the IASB project to replace IAS -39 Financial Instruments: Recognition and Measurement. 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. Portions of the standard remain in development and the full impact of the standard on the Company's financial statements will not be known until the project is complete.

#### (b) In May, 2011, the IASB released the following new standards which are effective for fiscal years beginning January 1, 2013 with earlier adoption permitted.

- (i) IFRS-10 Consolidated Financial Statements, supersedes 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, divides joint arrangements into two types, joint operations and joint ventures, each with their own accounting model. All joint arrangements are required to be reassessed on transition to IFRS 11 to determine their type to apply the appropriate accounting.
- (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.
- (iv) IFRS-13 Fair Value Measurement, defines 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 is currently assessing the expected impact, if any, that the adoption of these standards will have on its financial statements.

# ARSENAL ENERGY INC

## Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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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, 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.

(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. Related party transactions:

An officer of the Company is a partner in a law firm that provides legal services to the Company. During the year, the Company incurred a total of \$175,706 (2010 - \$ 262,265) for legal fees and disbursements. As at December 31, 2011, accounts payable include \$25,000 (December 31, 2010 - \$35,000) relating to these payments.

### 7. 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

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 7. Business acquisition (continued):

operating results commencing November 15, 2011. The Company incurred \$613,611 of transaction costs related to the acquisition. The following table presents the allocation of the purchase price based on estimated fair values:

Identifiable assets acquired and liabilities assumed:	
Property, plant and equipment	\$ 56,764,698
Prepaid expenses	675,574
Trade receivables	400,000
Inventory	202,344
Decommissioning obligations	(18,703,225)
<b>Total</b>	<b>\$ 39,339,391</b>

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	\$82,800,000
Net income for the year	7,900,000
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

## 8. Exploration and evaluation assets:

Cost or deemed cost	Total
Balance at January 1, 2010	\$ -
Additions	11,028,488
Transfer to property, plant and equipment	(4,046,054)
Transfer to exploration and evaluation expenses	(587,929)
<b>Balance at December 31, 2010</b>	<b>6,394,505</b>
Additions	9,363,845
Transfer to property, plant and equipment	(2,913,440)
Transfer to exploration and evaluation expenses	(3,744,741)
<b>Balance at December 31, 2011</b>	<b>\$ 9,100,169</b>

For the year ended December, 2011, \$1,555,130 (2010 - \$1,663,037) of seismic costs were recorded directly to exploration and evaluation expense in the consolidated statement of loss.

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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## 9. Property, plant and equipment:

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Cost or deemed cost	Total
Balance at January 1, 2010 (after transitional impairment)	\$ 77,989,725
Additions	14,947,866
Property acquisitions	2,259,529
Transfer from exploration and evaluation assets	4,046,054
Divestitures	(7,969,065)
Change in decommissioning obligations	1,109,054
Decommissioning obligations acquired and incurred	685,313
Capitalized share-based compensation	211,130
Changes in translati	

# ARSENAL ENERGY INC

## Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

### 9. Property, plant and equipment (continued):

During 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 gain of \$1,282,406).

### 10. Impairment loss:

As at December 31, 2011, 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 third party 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.

The following estimates were used in determining whether an impairment to the carrying value of the CGU's existed at December 31, 2011.

Benchmark reference price forecast	2012	2013	2014	2015	2016	2017	2018	2019
WTI (\$US/bbl)	100.00	102.00	104.05	106.10	108.25	110.40	112.60	114.85
Edmonton Par (\$CDN/bbl)	98.00	100.00	102.00	104.00	106.10	108.20	110.35	112.55
Bow River Hardisty (\$CDN/bbl)	81.20	81.10	80.00	82.00	84.10	86.20	88.35	90.55
AECO-C (\$CDN/mcf)	3.50	4.10	4.70	5.15	5.55	6.00	6.40	6.90
Edmonton Butanes (\$CDN/bbl)	83.30	85.00	86.70	88.40	90.20	91.95	93.80	95.65
Edmonton Pentanes (\$CDN/bbl)	102.90	105.00	107.10	109.20	111.40	113.60	115.85	118.20
Exchange rate (\$CDN/\$US)	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

After 2019 the price forecast escalates at 2% per year to the end of the reserve life and the exchange rate remains constant at 1.00.

During 2011 it was determined that the net book value of certain CGU's exceeded the recoverable amount and an impairment of \$5.5 million was recognized.

A one per cent increase in the assumed discount rate would result in an additional impairment of \$1.2 million while a ten percent decrease to the forward commodity price estimate would result in an additional impairment of \$3.8 million.

As at December 31, 2010, 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, based on discounted cash flows of proved plus probable reserves as estimated by the Company's third party reserve evaluators using forecast prices and costs and discount rates of between 12% and 14%. 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.

# ARSENAL ENERGY INC

## Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

### 10. Impairment loss (continued):

The following estimates were used in determining whether an impairment to the carrying value of the CGU's existed at December 31, 2010.

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

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

During 2010 it was determined that the net book value of certain CGU's exceeded the recoverable amount and an impairment of \$5.9 million was recognized.

### 11. Bank loan:

At May 31, 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. A review and update of the credit facility in November 2011, incorporated the \$38.6 million property acquisition and drilling results since June 2011, and resulted in an increase in the credit facility to \$75.0 million. 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 interest and other financing expenses, expensed seismic expenditures, realized gains or losses on risk management contracts and any unusual or non-recurring items.

The new 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 December 31, 2011, debt under the credit facility amounted to \$52,062,272 (December 31, 2010 – \$11,412,875) and includes \$5,000,000 (December 31, 2010 – \$5,000,000) of US dollar denominated borrowings.

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 11. Bank loan (continued):

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 December 31, 2011, the Company was in compliance with this covenant.

## 12. Decommissioning obligations:

	Year ended December 31, 2011	Year ended December 31, 2010
Decommissioning obligations, beginning of year	\$ 19,667,331	\$ 21,182,129
Obligations settled	(819,283)	(1,083,838)
Obligations acquired	18,703,225	20,216
Obligations disposed	(435,710)	(2,726,393)
Obligations incurred	621,681	683,760
Change in estimated future cash outflows/discount rate	(1,214,237)	1,109,054
Foreign currency translation	94,440	(273,639)
Accretion expense	708,499	756,042
Decommissioning obligations, end of year	\$ 37,325,946	\$ 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 \$37.3 million as at December 31, 2011 (December 31, 2010: \$19.7 million) based on an undiscounted inflation adjusted total future liability of \$52.4 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%). Due to revised cost estimates on our US operations, a decrease of \$2.7 million was recognized in our estimated future cash outflows.

## 13. Share capital:

At December 31, 2011 and December 31, 2010, 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.

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 13. Share capital (continued):

### (a) Issued

	Year ended December 31, 2011		Year ended December 31, 2010	
	Number of Shares	Share capital	Number of Shares	Share Capital
Balance, beginning of year	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	-	(1,694,307)	-	(1,161,279)
Transfer of share-based compensation on exercise of options	-	469,834	-	65,318
Issued on exercise of options	1,342,833	560,807	171,500	79,150
Repurchase of shares	(7,031,544)	(6,136,161)	(1,403,918)	(1,161,284)
Balance, end of year	157,282,261	\$136,859,986	140,812,472	\$122,609,238

### 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 December 31, 2011, all exploration costs had been incurred on this issuance.

On February 26, 2010, the Company issued 3,000,000 flow-through common shares at \$1.00 per share for gross proceeds of \$3,000,000. The terms of the share issue require the Company to incur Canadian Exploration Expenses in the amount of \$3,000,000 by December 31, 2011. As at December 31, 2011, 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.

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 13. Share capital (continued):

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	4,840,000	0.68
Exercised	(1,342,833)	0.42
Expirations	(390,000)	1.09
Forfeited	(1,167,997)	0.72
Balance, December 31, 2011	14,693,670	\$ 0.64

The following table summarizes information about the stock options outstanding and exercisable at December 31, 2011:

Options outstanding				Options exercisable		
Range of exercise prices	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	2.00	850,668	\$ 0.21	
\$0.36 to \$0.50	2,649,670	0.40	2.11	2,261,334	0.40	
\$0.51 to \$0.70	4,776,000	0.63	3.73	1,086,000	0.61	
\$0.71 to \$1.00	5,990,000	0.86	3.31	2,213,334	0.83	
Total	14,693,670	\$ 0.64	3.12	6,411,336	\$ 0.56	

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, 2011	Year ended December 31, 2010
Risk free interest rate	1.18 - 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%
Weighted average fair value per share	\$0.44	\$0.56

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 13. Share capital (continued):

### (c) Loss per share

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

	2011	2010
Basic and diluted:		
Loss per share basic and diluted	\$ (0.02)	\$ (0.05)
Weighted average shares outstanding:		
Basic	158,629,712	133,802,977
Diluted	158,629,712	133,802,977

In computing diluted loss per share for the year ended December 31, 2011, 14,693,670 (2010-12,754,500) 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. A total of 6,740,767 common shares could have been acquired under the bid representing 5% of the 134,815,340 common shares outstanding as of May 20, 2010. During 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.

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 December 31, 2011, the Company has 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.

## 14. 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.

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 14. Risk management and financial instruments (continued):

### 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, 2011, 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 2001 net loss of \$41,851.

#### 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, 2011 was \$11.1 million (2010 \$16.1 million). For the year ended December 31, 2011, a 1.0 percent change to the effective interest rate would have a \$111,000 impact on net loss (2010 - \$161,000).

Subsequent to year end 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.

(\$Cdn.)				
Subject of Contract	Term	Notional Quantity	Reference	Strike Price
30 day BA rate	Feb 13, 2012 - Feb 13, 2015	\$20,000,000	CAD-BA-CDOR	1.50%

#### 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, 2011, the Company had three crude oil swaps in-place fixing the price of future production for a specific period of time. All risk management contracts are denominated in Canadian dollars. For the year ended December 31, 2011, the Company recorded a realized commodity contract gain of \$3,356,993 (December 31, 2010 - \$1,788,624 gain) and an unrealized commodity contract loss of \$2,355,109 (December 31, 2010 - \$1,423,891 loss).

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

	As at December 31, 2011	As at December 31, 2011
Total fair value consists of the following:		
Fair value - current portion	\$ (2,291,080)	\$ (993,345)
Fair value - long-term portion	\$ (1,484,526)	\$ (427,168)
Total fair value, end of period	\$ (3,775,606)	\$ (1,420,513)

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 14. 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:

	Years ended December 31	
	2011	2010
Fair value, beginning of year	\$(1,420,513)	\$3,378
Changes in fair value	1,001,900	364,733
Settlement paid (received)	(3,356,993)	(1,788,624)
Fair value, end of year	\$(3,775,606)	\$(1,420,513)

The Company had the following risk management contracts outstanding as at December 31, 2011.

(\$Cdn.)				
Commodity Sold	Volume Sold	Remaining Term	Cdn \$ Pricing	Fair Value
Oil	300 bbl per day	January 1, 2012 - Dec 31, 2013	\$92.10 per bbl	\$ (1,580,355)
Oil	400 bbl per day	January 1, 2012 - Dec 31, 2013	\$92.10 per bbl	(2,107,139)
Oil	300 bbl per day	January 1, 2012 - Dec 31, 2012	\$100.00 per bbl	(88,112)
				\$ (3,775,606)

On February 10, 2012, the Company entered into a crude oil commodity price contract to sell 300 barrels of production per day from January 1, 2013 until December 31, 2013 at a price of \$101.00 Cdn per barrel.

Commodity price sensitivity:

Commodity Price	
Oil production sold under risk management contract (barrels)	621,500
Price Change (per bbl)	\$ 1.00
<b>Sensitivity - loss before income tax</b>	<b>\$ 621,500</b>

### 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

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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## 14. Risk management and financial instruments (continued):

valuations are based on inputs including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace.

- Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

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

### c) Credit risk:

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint interest partners and petroleum and natural gas marketers. The maximum exposure to credit risk at year end is as follows:

	December 31, 2011	December 31, 2010
Accounts receivable	\$ 11,677,448	\$ 8,099,902

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, 2011 the Company's receivables consisted of \$3,105,667 (2010 - \$2,036,210) from joint interest partners the majority of which has either been collected or is expected to be collected within the next 60 days, \$8,057,059 (2010 - \$5,556,153) of receivables from petroleum and natural gas marketers, which have been collected and \$514,721 (2010 - \$507,539) of other receivables. At December 31, 2011, Arsenal had approximately \$757,492 (2010 - \$831,853) of receivables that are considered past due and collection efforts, including the taking of production and consideration of legal action have commenced.

Receivables from petroleum and natural gas marketers are normally collected on the 25<sup>th</sup> day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint interest receivables are typically collected within one to three months of the joint interest bill being issued to the partner. The Company attempts to mitigate the risk from joint interest receivables by obtaining partner approval of significant capital expenditures and payment of cash advances prior to expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances are 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.

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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## 14. Risk management and financial instruments (continued):

### 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 Company processes invoices within a normal payment period. The Company maintains a revolving credit facility, as outlined in note 11, that 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.

## 15. Capital management:

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

The Company considers 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 (a non-GAAP measure) is calculated as cash flow from operations before changes in non-cash working capital, decommissioning obligations settled and exploration and evaluation 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 : 1.5 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

# ARSENAL ENERGY INC

## Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

### 15. Capital management (continued):

thereto. The Company has targeted a debt to equity ratio of 0.5 : 1. This ratio will also fluctuate over time depending on the state of equity markets and the results of operations.

At December 31, 2011, the Company's net debt to annualized funds flow (Q4 cash flow adjusted for significant and non-recurring realized commodity gains or losses and seismic expenditures expensed) ratio was 1.65 : 1 and its debt to equity ratio was 1.02 : 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. The property acquisition of \$38.6 million in November 2011 increased debt thereby increasing the debt to annualized funds flow ratio. At December 31, 2011, both the net debt to annualized funds flow ratio and the debt to equity ratio are within an acceptable target range as established in management's strategic goals and guidelines. Key factors that will determine if the Company will be able to remain within its established guidelines are production rates from drilling, commodity (particularly crude) prices, interest and foreign exchange rates and the magnitude and timing of the Company's capital expenditure program.

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	December 31, 2011	December 31, 2010
Cash and cash equivalents	\$ 625,541	\$ 1,448,009
Accounts receivable, prepaids and inventory	13,137,938	8,497,911
Accounts payable and accrued liabilities	(17,452,738)	(17,320,820)
Working capital deficiency	\$ (3,689,259)	\$ (7,374,900)
Bank loan	(52,062,272)	(11,412,875)
Net debt	\$ (55,751,531)	\$ (18,787,775)
Annualized funds flow <sup>1,2</sup>	\$ 33,762,060	\$ 20,167,748
Net debt to annualized funds flow ratio	1.65	0.93
Shareholders' equity	\$ 54,872,949	\$ 40,507,734
Debt to equity	1.02	0.46

<sup>1</sup> Excludes significant realized gains and losses on commodity contracts and seismic expenses

<sup>2</sup> Based on the last quarter's annualized funds flow

# ARSENAL ENERGY INC

## Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

### 16. 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:

	2011	2010
Income (loss) before income tax	\$ 539,000	\$ (5,220,420)
Combined federal and provincial tax rate	26.56%	28.11%
Expected tax provision (reduction)	143,158	(1,467,460)
Increase (decrease) in taxes resulting from:		
Share-based compensation	373,208	295,336
Change in tax rates	32,745	(114,108)
Tax impact of foreign jurisdictions	1,186,082	461,124
Flow through shares	716,947	917,572
Other	424,942	(614,917)
Unrecognized deferred tax asset	199,366	1,593,353
	\$ 3,084,214	\$ 1,070,899

The statutory tax rate decreased to 26.5% in 2011 from 28% in 2010 as a result of tax legislation enacted in 2007.

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

	2011	
	Canadian Operations	US Operations
Deferred tax assets:		
Decommissioning obligation	\$ 8,544,052	\$ 1,299,920
Non-capital losses	2,332,498	4,875,291

Deferred tax liabilities:

# ARSENAL ENERGY INC

## Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

### 16. Income tax expense (continued):

Based on a 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 \$1,775,276.

The Company's assets have a tax basis of \$125,581,678 at December 31, 2011 (December 31, 2010 - \$79,261,029) available for deduction against future taxable income. The non-capital loss carry forwards in Canada of \$14,673,265 (December 31, 2010 - \$15,166,848) expire between 2023 and 2028. The following table summarizes the tax pools:

	December 31, 2011		December 31, 2010	
	Canada	US	Canada	US
Cumulative Canadian Oil and Gas Property Expense	\$ 33,535,090	\$ -	\$ -	\$ -
Cumulative Canadian Development Expense	7,868,885	-	9,079,898	-
Cumulative Canadian Exploration Expense	14,240,008	-	19,642,403	-
Undepreciated Capital Cost	28,588,017	7,383,500	20,410,665	4,276,844
Share Issue Costs	2,625,872	-	1,912,862	-
Non-capital Losses	14,673,265	12,729,217	15,166,848	4,782,483
Capital Losses and Other	3,937,823	-	3,989,026	-
Balance, end of period	\$105,468,960	\$20,122,718	\$ 70,201,702	\$ 9,059,327

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

	2011	2010
Non-capital losses	\$ 5,343,272	\$ 6,703,332
Risk management contracts	4,002,160	968,555
Share issue costs	2,625,872	1,912,864
Capital losses	3,565,040	3,588,184
Other	372,784	400,844
	\$ 15,909,128	\$ 13,573,779

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

	January 1, 2010	Recognized in profit and loss	Recognized in equity and other	December 31, 2010
Decommissioning obligation	\$6,020,529	\$ (436,046)	\$ -	\$ 5,584,483
Risk management contracts	55,460	117,640	-	173,100
Non-capital losses	5,146,927	(1,218,926)	-	3,928,001
Property, plant and equipment	(9,264,158)	1,000,640	(481,021)	(8,744,539)
Other	(183,482)	(534,207)	78,244	(639,445)
	\$1,775,276	\$(1,070,899)	\$ (402,777)	\$ 310,600

# ARSENAL ENERGY INC

## Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

### 16. Income tax expense (continued):

	December 31, 2010	Recognized in profit and loss	Recognized in equity and other	December 31, 2011
Decommissioning obligation	\$5,584,483	\$ 4,259,489	\$ -	\$ 9,843,972
Risk management contracts	173,100	(173,100)	-	-
Non-capital losses	3,928,001	3,279,788	-	7,207,789
Property, plant and equipment	(8,744,539)	(10,435,423)	(792,967)	(19,972,929)
Other	(639,445)	(14,968)	(145,448)	(799,861)
	\$310,600	\$(3,084,214)	\$(938,415)	\$(3,721,029)

### 17. Supplemental cash flow information:

Year ended December 31	2011	2010
Change in non-cash working capital items:		
Accounts receivable	\$ (3,577,546)	\$ (1,629,857)
Prepaid expenses and deposits	(580,345)	134,799
Inventory	(274,176)	-
Accounts payable and accrued liabilities	131,918	2,542,631
	(4,300,149)	1,047,573
Amounts relating to operating activities	(1,598,245)	(4,042,961)
Amounts relating to financing activities	(126,304)	56,839
Amounts relating to investing activities	(2,575,600)	5,033,695
	(4,300,149)	1,047,573
Taxes Paid	\$ 5,771	\$ 32,098
Interest paid	\$ 412,211	\$ 710,461

### 18. Finance expenses:

Year ended December 31	2011	2010
Accretion of decommissioning obligation	\$ 708,499	\$ 756,042
Interest and other financing fees	933,990	1,019,755
Transaction costs	613,611	-
	\$2,256,100	\$1,775,797

# ARSENAL ENERGY INC

## Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

### 19. 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, 2011 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	34,116,119	24,349,818	58,465,937
Income (loss) before income taxes	(9,563,911)	10,102,911	539,000
Operating income <sup>1</sup>	16,721,459	14,140,246	30,861,705
Exploration and evaluation assets	9,100,169	-	9,100,169
Property, plant and equipment	108,386,178	37,808,164	146,194,342
Capital expenditures	7,392,266	23,714,888	31,107,154
Exploration and evaluation expenditures	9,363,845	-	9,363,845
Property acquisitions	38,574,702	-	38,574,702
Property dispositions	(621,914)	-	(621,914)

December 31, 2010 (\$Cdn.)	Canada	U.S.	Total
Oil and gas revenue	28,143,213	15,522,507	43,665,720
Income (loss) before income taxes	(9,745,677)	4,525,257	5,220,420
Operating income <sup>1</sup>	12,229,513	8,325,010	20,554,523
Exploration and evaluation assets	6,394,505	-	6,394,505
Property, plant and equipment	56,003,187	18,327,839	74,331,026
Capital expenditures	7,311,489	7,616,163	14,927,652
Exploration and evaluation expenditures	11,028,488	-	11,028,488
Property acquisitions	75,480	2,184,049	2,259,529
Property dispositions	(5,919,077)	-	(5,919,077)

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

### 20. Commitments and contingencies:

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

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

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

2012	\$	780,672
2013		351,792
2014		267,930
2015		226,375
2016		176,813
Thereafter		18,705
Total commitment	\$	1,822,287

The Company's office lease expires on July 31, 2012. The Company has exercised its option to extend its current lease for an additional five years at market rates to be determined on May 1, 2012. The Company expects the range to be \$22.00 - \$25.00 per square foot. The Company will also be required to pay building operating costs, property taxes and parking estimated to be approximately an additional \$16.50 per square foot.

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 20. 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 operations in the year of resolution.

## 21. Personnel expenses:

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

	2011	2010
Salaries, wages and benefits	\$ 3,179,804	\$ 2,644,272
Director fees	63,250	40,000
Share based payments (i)	1,405,166	1,050,827
Total employee remuneration	4,648,220	3,735,099
Capitalized portion of total remuneration	941,480	743,130
	\$ 5,589,700	\$ 4,478,229

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:

	2011	2010
Salaries, wages and benefits	\$ 1,314,662	\$ 1,284,524
Director fees	63,250	40,000
Termination benefits	1,086,000	1,023,000
Share-based payments (i)	957,505	745,480
	\$ 3,421,417	\$ 3,093,004

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

# ARSENAL ENERGY INC

## Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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### 22. Reconciliation 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 proved and probable reserve volumes.
- Decommissioning obligations exemption that allows any changes in decommissioning obligations on transition to IFRS to be adjusted through opening deficit.
- Share-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 have been applied in preparing the consolidated financial statements for the year ended December 31, 2011 and the comparative information as at and for the year ended December 31, 2010, the financial statements for the year ended December 31, 2010 and the preparation of the opening IFRS balance sheet at January 1, 2010, the Company's date of transition to IFRS.

In preparing its opening IFRS statement of financial position and comparative information for the year ended December 31, 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.

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 22. Reconciliation from Canadian GAAP to IFRS (continued):

At the date of IFRS transition – January 1, 2010:

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Assets</b>				
Current assets:				
Cash and cash equivalents		\$ 1,325,915	\$ -	\$ 1,325,915
Accounts receivable		6,470,045	-	6,470,045
Prepaid expenses and deposits		532,808	-	532,808
Risk management contracts		126,749	-	126,749
		8,455,517	-	8,455,517
Reclamation deposit		157,650	-	157,650
Exploration and evaluation assets		-	-	-
Property, plant and equipment	C	108,267,249	(30,277,524)	77,989,725
Deferred taxes	A	-	1,775,276	1,775,276
		\$116,880,416	\$ (28,502,248)	\$88,378,168
<b>Liabilities</b>				
Current liabilities:				
Accounts payable and accrued liabilities		\$ 14,778,189	\$ -	\$14,778,189
Bank loan		22,290,000	-	22,290,000
Deferred taxes	A	36,757	(36,757)	-
		37,104,946	(36,757)	37,068,189
Flow through share premium	F	-	346,492	346,492
Risk management contracts		123,371	-	123,371
Deferred taxes	A,C,E,F	7,860,589	(7,860,589)	-
Decommissioning obligations	E	14,044,639	7,137,490	21,182,129
		59,133,545	(413,364)	58,720,181
<b>Shareholders' Equity</b>				
Common shares	F	100,955,986	5,515,697	106,471,683
Contributed surplus	G	5,980,601	189,946	6,170,547
Accumulated other comprehensive loss	I	(507,506)	507,506	-
Deficit	A,C,E,I	(48,682,210)	(34,302,033)	(82,984,243)
		57,746,871	(28,088,884)	29,657,987
		\$116,880,416	\$ (28,502,248)	\$88,378,168

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 22. Reconciliation from Canadian GAAP to IFRS (continued):

At the end of the last reporting year under Canadian CGAAP – December 31, 2010:

	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Assets</b>				
Current assets:				
Cash and cash equivalents		\$ 1,448,009	\$ -	\$ 1,448,009
Accounts receivable		8,099,902	-	8,099,902
Prepaid expenses and deposits		398,009	-	398,009
Deferred taxes	A	288,069	(288,069)	-
		10,233,989	(288,069)	9,945,920
Reclamation deposit		149,190	-	149,190
Exploration and evaluation assets	B	-	6,394,505	6,394,505
Property, plant and equipment	B,C	103,229,339	(28,898,313)	74,331,026
Deferred taxes	A	-	1,775,276	1,775,276
		\$113,612,518	\$(21,016,601)	\$92,595,917
<b>Liabilities</b>				
Current liabilities:				
Accounts payable and accrued liabilities		\$17,320,820	\$ -	\$17,320,820
Bank loan		11,412,875	-	11,412,875
Risk management contracts		993,344	-	993,344
		29,727,039	-	29,727,039
Flow through share premium	F	-	792,968	792,968
Risk management contract		427,169	-	427,169
Deferred taxes	A,C,E,F	4,071,145	(2,597,469)	1,473,676
Decommissioning obligations	E	12,465,634	7,201,697	19,667,331
		46,690,987	5,397,196	52,088,183
<b>Shareholders' Equity</b>				
Common shares	F	117,126,441	5,482,797	122,609,238
Contributed surplus	G	6,905,561	468,493	7,374,054
Accumulated other comprehensive loss	I	(753,184)	553,188	(199,996)
Deficit	A,C,E,I	(56,357,287)	(32,918,275)	(89,275,562)
		66,921,531	(26,413,797)	40,507,734
		\$113,612,518	\$(21,016,601)	\$92,595,917

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

## 22. Reconciliation from Canadian GAAP to IFRS (continued):

Reconciliation of consolidated statement of loss and comprehensive loss for the year ended December 31, 2010:

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
<b>Revenues:</b>				
Oil and natural gas revenue		\$43,665,720	\$ -	\$43,665,720
Royalties		(7,826,810)	-	(7,826,810)
		35,838,910	-	35,838,910
Realized gain (loss) on risk management contracts		1,788,624	-	1,788,624
Unrealized gain (loss) on risk management contracts		(1,423,891)	-	(1,423,891)
Other income		19,507	-	19,507
		36,223,150	-	36,223,150
<b>Expenses:</b>				
Operating	C	14,042,198	423,135	14,465,333
Transportation		819,054	-	819,054
General and administrative		3,586,124	-	3,586,124
Exploration and evaluation	C	-	2,250,984	2,250,984
Property, plant and equipment impairment	C	-	5,948,300	5,948,300
Gain on divestitures	H	-	(1,282,406)	(1,282,406)
Depletion and depreciation	C,D	28,581,552	(15,738,167)	12,843,385
Share-based compensation	G	817,239	233,588	1,050,827
		47,846,167	(8,164,566)	39,681,601
Loss from operations		(11,623,017)	(8,164,566)	(3,458,451)
<b>Financial items</b>				
Interest and other financing charges		1,019,755	-	1,019,755
Exploration and evaluation	E	-	756,042	756,042
Foreign exchange (gain)		(13,828)	-	(13,828)
		1,005,927	756,042	1,761,969
Loss before tax		(12,628,944)	(7,408,524)	(5,220,420)
Deferred tax (benefit)	C,E,F	(4,953,867)	6,024,766	1,070,899
Net loss for the year		\$(7,675,077)	\$ 1,383,758	\$(6,291,319)
Translation loss on foreign operations		(245,678)	45,682	(199,996)
Net loss and comprehensive loss		\$(7,920,755)	\$ 1,429,440	\$(6,491,315)
<b>Loss per share:</b>				
Basic and diluted		\$ (0.06)		\$ (0.05)

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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## **22. Reconciliation 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. The related income tax effect of the below noted adjustments have also been reflected in these statements.
  
- (B)

# ARSENAL ENERGY INC

Notes to Consolidated Financial Statements

For the years ended December 31, 2011 and 2010

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## 22. Reconciliation 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 (December 31, 2010 - \$ 6.4 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 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 share-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 \$233,588 increase to share-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 \$1.3 million 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 certain properties 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.