

Financial Statements of

ARCAN RESOURCES LTD.

Years ended December 31, 2010 and 2009

Independent auditors' report

To the Shareholders

We have audited the accompanying financial statements of Arcan Resources Ltd., which comprise the balance sheets as at December 31, 2010 and 2009, the statements of operations, comprehensive loss and deficit and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of 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 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 financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the 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 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 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 financial statements present fairly, in all material respects, the financial position of Arcan Resources Ltd. as at December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) "KPMG LLP"

Chartered Accountants

Calgary, Canada

April 5, 2011

ARCAN RESOURCES LTD.

Balance Sheets

As at December 31,

	2010	2009
Assets		
Current assets:		
Accounts receivable	\$ 15,609,687	\$ 10,011,769
Prepays and deposits	1,528,943	935,313
Future income taxes (note 7)	591,792	-
	<u>17,730,422</u>	<u>10,947,082</u>
Property, plant, and equipment (note 4)	272,045,074	140,304,312
	<u>\$ 289,775,496</u>	<u>\$ 151,251,394</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 43,266,825	\$ 17,140,125
Bank loan (note 5)	-	28,585,629
Fair value of commodity contracts (note 11)	2,233,179	-
	<u>45,500,004</u>	<u>45,725,754</u>
Bank loan (note 5)	20,822,798	-
Asset retirement obligations (note 6)	10,848,036	5,370,818
Future income taxes (note 7)	3,430,837	4,687,265
	<u>80,601,675</u>	<u>55,783,837</u>
Shareholders' equity:		
Share capital (note 8)	210,382,465	93,714,116
Share purchase loan (note 8)	-	(100,000)
Contributed surplus (note 9)	6,086,001	4,080,040
Deficit	(7,294,645)	(2,226,599)
	<u>209,173,821</u>	<u>95,467,557</u>
Commitments (note 12)		
Subsequent events (note 13)		
	<u>\$ 289,775,496</u>	<u>\$ 151,251,394</u>

See accompanying notes to financial statements.

Approved by the Board of Directors:

(signed) "Ed Gilmet" Director

(signed) "Andy Fisher" Director

ARCAN RESOURCES LTD.

Statements of Operations, Comprehensive Loss and Retained Earnings (Deficit)

For the years ended December 31,

	2010	2009
Revenue:		
Petroleum and natural gas	\$ 55,574,703	\$ 27,289,747
Royalties	(14,704,221)	(7,116,429)
Unrealized loss on commodity contracts (note 11)	(2,233,179)	-
Realized loss on commodity contracts (note 11)	-	(1,439,613)
Interest and other revenue	24,138	3,348
	<u>38,661,441</u>	<u>18,737,053</u>
Expenses:		
Operating	11,110,135	8,081,714
General and administrative	8,982,000	4,616,176
Interest	1,780,442	1,543,357
Accretion	710,926	414,170
Depletion and depreciation	21,499,834	11,293,062
	<u>44,083,337</u>	<u>25,948,479</u>
Loss before income taxes	(5,421,896)	(7,211,426)
Future income tax reduction (note 7)	353,850	1,468,806
Loss and comprehensive loss	<u>(5,068,046)</u>	<u>(5,742,620)</u>
Retained earnings (deficit), beginning of year	(2,226,599)	3,516,021
Deficit, end of year	<u>\$ (7,294,645)</u>	<u>\$ (2,226,599)</u>
Loss per share (note 8):		
Basic	\$ (0.07)	\$ (0.15)
Diluted	\$ (0.07)	\$ (0.15)

See accompanying notes to financial statements.

ARCAN RESOURCES LTD.

Statements of Cash Flows

For the years ended December 31,

	2010	2009
Cash provided by (used in):		
Operating:		
Loss	\$ (5,068,046)	\$ (5,742,620)
Items not involving cash:		
Depletion and depreciation	21,499,834	11,293,062
Stock-based compensation	3,856,382	942,236
Accretion	710,926	414,170
Unrealized loss on commodity contracts	2,233,179	-
Future income tax reduction	(353,850)	(1,468,806)
Reclamation costs	(139,858)	(92,714)
	22,738,567	5,345,328
Change in non-cash working capital	(3,107,074)	(1,017,653)
	19,631,493	4,327,675
Financing:		
Bank loan	(7,762,831)	(1,047,058)
Issue of common shares, net of costs	113,323,558	11,776,856
Share purchase loan	100,000	-
	105,660,727	10,729,798
Investing:		
Property, plant and equipment	(95,524,510)	(11,495,177)
Property acquisition (note 4)	(52,809,936)	-
Change in non-cash working capital	23,042,226	(3,562,296)
	(125,292,220)	(15,057,473)
Change in cash	-	-
Cash, beginning of year	-	-
Cash, end of year	\$ -	\$ -
Supplementary disclosure:		
Interest paid	\$ 1,742,760	\$ 1,562,197

Cash is defined as cash and cash equivalents.

See accompanying notes to financial statements.

ARCAN RESOURCES LTD.

Notes to Financial Statements

Years ended December 31, 2010 and 2009

1. Basis of presentation:

Arcan Resources Ltd. ("Arcan" or the "Company") is a publicly listed company involved in the business of oil and natural gas exploration, development and production in western Canada.

2. Significant accounting policies:

The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. The preparation of these financial statements, in conformity with generally accepted accounting principles, requires management to make estimates and assumptions that affect the amounts reported in the statements and accompanying notes. As a result, actual amounts could differ from estimated amounts.

Specifically, the amounts recorded for depletion and depreciation of petroleum and natural gas properties and the provision for asset retirement obligations and abandonment costs are based on estimates. The ceiling test is based on estimates of reserves, production rates, oil and natural gas prices, future costs and other relevant assumptions. The amounts for stock-based compensation are based on estimates of risk-free rates, expected lives and volatility. Future income taxes are based on estimates as to the timing of the reversal of temporary differences and tax rates currently substantively enacted. The fair value estimates for commodity contracts are based on expected future petroleum and natural gas prices and volatility in those prices. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

(a) Property, plant and equipment:

The Company's activities are related to the acquisition of, exploration for and development of petroleum and natural gas properties. The Company follows the full cost method of accounting for petroleum and natural gas operations.

All costs of exploring for and developing petroleum and natural gas properties and related reserves are capitalized into a cost centre. Such costs include those related to lease acquisition, geological and geophysical activities, lease rentals on non-producing properties, drilling of productive and non-productive wells, tangible production equipment, asset retirement costs, and that portion of general and administrative expenses directly attributable to exploration and development activities. Proceeds received from the disposal of properties are normally deducted from the full cost pool without recognition of a gain or loss. When a significant portion of properties is sold, resulting in a change to the depletion rate of 20 percent or more, a gain or loss is recorded and reflected in the statement of operations.

Depletion of petroleum and natural gas properties and depreciation of production equipment, excluding costs related to unproved properties, are calculated using the unit-of-production method based upon estimated proved reserves, before royalties, as determined by independent petroleum engineers. For purposes of the calculation, natural gas reserves and

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production are converted to equivalent volumes of petroleum based upon relative energy content.

Costs of acquiring unproved properties are initially excluded from the full cost pool and are assessed each reporting period to ascertain whether impairment has occurred. When proved reserves are assigned to the property or the property is considered to be impaired, the cost of the property or the amount of impairment is added to the full cost pool.

Petroleum and natural gas properties are evaluated in each reporting period to determine whether the carrying amount in a cost centre is recoverable and does not exceed the fair value of the properties in the cost centre.

The carrying amounts are assessed to be recoverable when the sum of the undiscounted cash flows expected from the production of proved reserves, the lower of cost and market of unproved properties and the cost of major development projects exceeds the carrying amount of the cost centre. When the carrying amount is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves, the lower of cost and market of unproved properties and the cost of major development projects of the cost centre. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

Computer and office equipment are recorded at cost and amortized on a declining balance basis using rates of 30% and 20%, respectively per annum.

(b) Interests in joint operations:

A portion of the Company's exploration and development activities are conducted jointly with others and, accordingly, the financial statements reflect only the Company's proportionate interest in such activities.

(c) Cash and cash equivalents:

Cash and cash equivalents are comprised of cash and all investments that are highly liquid in nature and generally have a maturity date of three months or less.

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Years ended December 31, 2010 and 2009

2. Significant accounting policies (continued):

(d) Asset retirement obligations:

The Company uses the asset retirement obligation method of recording the future cost associated with removal, site restoration and asset retirement costs. The fair value of the liability for the Company's asset retirement obligations is recorded in the period in which it is incurred, discounted to its present value using the Company's credit-adjusted, risk-free interest rate and the corresponding amount is recognized by increasing the carrying amount of petroleum and natural gas properties. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is charged to earnings in the period. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost could also result in an increase or decrease to the obligation. Actual costs incurred upon settlement of the retirement obligations are charged against the obligation to the extent of the liability recorded.

(e) Financial instruments:

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument to another entity. Upon initial recognition all financial instruments, including all derivatives, are recognized on the balance sheet at fair value. Subsequent measurement is then based on the financial instruments being classified into one of five categories: held for trading, held to maturity, loans and receivables, available for sale and other liabilities. The Company has designated its cash and cash equivalents as held for trading which are measured at fair value. Accounts receivable are classified as loans and receivables which are measured at amortized cost. Accounts payable and accrued liabilities and bank debt are classified as other liabilities which are measured at amortized cost, which is determined using the effective interest method.

The Company will assess at each reporting period whether a financial asset is impaired with any impairment recorded in earnings.

The Company is exposed to market risks resulting from fluctuations in commodity prices, foreign exchange rates and interest rates in the normal course of operations. A variety of derivative instruments may be used by the Company to reduce its exposure to fluctuations in commodity prices, foreign exchange rates, and interest rates. The Company does not use these derivative instruments for trading or speculative purposes. The Company considers all of these transactions to be economic hedges, however, the majority of the Company's contracts do not qualify or have not been designated as hedges for accounting purposes. As a result, all derivative contracts are classified as held for trading and are recorded on the balance sheet at fair value, with changes in the fair value recognized in net income, unless specific hedge criteria are met. The fair values of these derivative instruments are based on an estimate of the amounts that would have been received or paid to settle these instruments prior to maturity given future market prices and other relevant factors.

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Years ended December 31, 2010 and 2009

2. Significant accounting policies (continued):

(e) Financial instruments (continued):

The Company has elected to account for its physical delivery sales contracts, which were 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 on an accrual basis rather than as non-financial derivatives.

The Company measures and recognizes embedded derivatives separately from the host contracts when the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract, when it meets the definition of a derivative and when the entire contract is not measured at fair value. Embedded derivatives are recorded at fair value.

The Company expenses all transaction costs incurred, in relation to the acquisition of a financial asset or liability, against the related financial asset or liability. Bank debt is presented net of deferred interest payments, with interest recognized in earnings on an effective interest basis.

The Company applies trade-date accounting for the recognition of a purchase or sale of cash equivalents and derivative contracts.

(f) Future income taxes:

The Company uses the asset and liability method for calculating future income taxes. Temporary differences arising from the differences between the tax basis of an asset or liability and the carrying amount on the balance sheet are used to calculate future income tax assets or liabilities. Future income tax assets or liabilities are calculated using the currently enacted, or substantively enacted, tax rates anticipated to apply in the periods that the temporary differences are expected to reverse. A valuation allowance is recorded against any future income tax assets if it is more likely than not that the asset will not be realized.

(g) Flow-through shares:

The resource expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are renounced to investors in accordance with tax legislation. The future tax liability and share capital are adjusted by the estimated cost of the renounced tax deductions when the expenditures are renounced.

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Years ended December 31, 2010 and 2009

2. Significant accounting policies (continued):

(h) Stock-based compensation:

The Company uses the fair value method for valuing stock option grants and warrants. Under this method, compensation cost attributable to all share options and warrants granted is measured at fair value at the grant date and expensed over the vesting period with a corresponding increase to contributed surplus. Upon the exercise of the stock options and warrants, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

(i) Revenue recognition:

Petroleum and natural gas revenues are recognized when the title and risks pass to the purchaser and collection is reasonably assured.

(j) Per share amounts:

Basic per share information is computed by dividing earnings by the weighted average number of common shares outstanding for the period. The weighted average shares that are issued in consideration for a share loan agreement are deducted from the weighted average common shares outstanding for the period. The treasury stock method is used to determine the diluted per share amounts, whereby any proceeds from the stock options, warrants or other dilutive instruments are assumed to be used to purchase common shares at the average market price during the period. The weighted average number of shares outstanding is then adjusted by the net change.

3. Future accounting policies:

International Financial Reporting Standards:

On January 1, 2011, International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board will become the generally accepted accounting principles in Canada. The adoption date of January 1, 2011 will require the restatement, for comparative purposes, of amounts reported by Arcan for the year ended December 31, 2010, including the opening balance sheet as at January 1, 2010. The transition from Canadian GAAP to IFRS is significant with differences affecting the financial position and results of operations. Arcan is finalizing the impact on its financial statements of the convergence of GAAP with IFRS.

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Years ended December 31, 2010 and 2009

4. Property, plant and equipment:

	2010	2009
Petroleum and natural gas properties	\$ 337,677,398	\$ 184,436,802
Accumulated depletion and depreciation	(65,632,324)	(44,132,490)
	<u>\$ 272,045,074</u>	<u>\$ 140,304,312</u>

At December 31, 2010, petroleum and natural gas properties included undeveloped properties of \$26.1 million (2009 - \$9.8 million), which have been excluded from the depletion calculation. Future development costs of proved reserves of \$141.2 million (2009 - \$27.6 million) have been included in the depletion calculation.

During the year ended December 31, 2010, the Company acquired certain working interests in petroleum and natural gas properties for cash of \$52.8 million, with associated asset retirement obligations of \$4.1 million.

The Company applied the ceiling test to its capitalized assets at December 31, 2010 and determined that there was no impairment of costs requiring a write-down. For the purposes of the December 31, 2010 impairment test of petroleum and natural gas properties, the following benchmark prices were used:

	WTI Oil (\$US/bbl)	Foreign Exchange Rate	WTI Oil (\$Cdn/bbl)	Arcan Price Oil & NGL	AECO Gas (\$Cdn/mcf)	Arcan Price Gas
2011	\$ 88.00	0.980	\$ 89.80	\$ 82.58	\$ 4.16	\$ 3.87
2012	89.00	0.980	90.82	85.69	4.74	4.51
2013	90.00	0.980	91.84	87.27	5.31	5.23
2014	92.00	0.980	93.88	89.24	5.77	5.77
2015	95.17	0.980	97.11	92.38	6.22	6.30
2016	97.55	0.980	99.54	94.75	6.53	6.65
2017	100.26	0.980	102.31	97.48	6.76	6.93
2018	102.74	0.980	104.84	99.95	6.90	7.10
2019	105.45	0.980	107.60	102.64	7.06	7.23
2020	107.56	0.980	109.76	104.75	7.21	7.38
2021	+2.0%/yr	0.980	+2.0%/yr	106.91	+2.0%/yr	7.38

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Years ended December 31, 2010 and 2009

5. Bank loan:

	2010	2009
Bank loan	\$ 20,822,798	\$ 28,585,629

The Company has a \$90 million syndicated extendible, revolving term credit facility and a \$10 million non-syndicated extendible revolving operating term credit facility for total available credit facilities of \$100 million (the "Facilities"). The Facilities are available on a revolving basis until May 31, 2011. On May 31, 2011, at the Company's discretion, the Facilities are available on a non-revolving basis for a period of one year, at which time the Facilities would be due and payable. Alternatively, the Facilities may be extended for a further 364 day period at the request of the Company, subject to approval by the lenders. Interest on the Facilities is calculated at the bank prime rate of interest, plus an applicable facility margin depending upon certain ratios. The \$100 million borrowing base is subject to a semi-annual and annual review by the bank. As the available lending limits of the Facilities are based on the bank's interpretation of the Company's reserves and future commodity prices, there can be no assurance as to the amount of the facilities that will be determined at each scheduled review. The Facilities are secured by a \$500 million first floating charge debenture and a general security agreement over all Company assets. Pursuant to the terms of the credit facilities, the Company has provided the covenant that at all times its working capital ratio shall be not less than 1 to 1. The working capital ratio is defined under the terms of the Facilities as current assets, including the undrawn portion of the Facilities, to current liabilities, excluding any current bank indebtedness under the Facilities. The Company is compliant with this covenant at December 31, 2010. This facility had an effective interest rate of 5.25% at December 31, 2010 (2009 – 4.75%).

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6. Asset retirement obligations:

The Company's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The Company estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations at December 31, 2010 is \$20.9 million (2009 - \$11.4 million), which will be incurred between 2012 and 2020. The majority of the costs are expected to be incurred between 2018 and 2019. An inflation rate of 2% (2009 - 2%) was used to inflate the costs, and a credit-adjusted risk-free rate of 8% - 10% (2009 - 8% - 10%) was used to calculate the fair value of the asset retirement obligations.

	2010	2009
Balance, beginning of year	\$ 5,370,818	\$ 4,785,428
Liabilities incurred	777,165	230,818
Liabilities incurred on acquisition (note 4)	4,072,144	-
Accretion expense	710,926	414,170
Changes in estimates	56,841	33,116
Reclamation costs	(139,858)	(92,714)
Balance, end of year	\$ 10,848,036	\$ 5,370,818

7. Taxes:

The difference between the expected income tax provision based on the combined federal and provincial statutory tax rate and the amount actually provided for is as follows:

	2010	2009
Loss before income taxes	\$ (5,421,896)	\$ (7,211,426)
Combined federal and provincial statutory rate	28.0%	29.0%
Expected future income tax reduction	\$ (1,518,131)	\$ (2,091,314)
Stock-based compensation	1,079,787	273,248
Future tax rate reductions and other	84,494	349,260
Future income tax reduction	\$ (353,850)	\$ (1,468,806)

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7. Taxes (continued):

The components of the future income tax liability are as follows:

	2010	2009
Share issue costs	\$ (1,703,739)	\$ (388,813)
Asset retirement obligations	(2,712,009)	(1,342,705)
Non-capital losses	(7,585,729)	(7,552,350)
Fair value of commodity contracts	(591,792)	-
Property, plant and equipment	15,432,314	13,971,133
Future income tax	\$ 2,839,045	\$ 4,687,265

The Company has recognized the benefit of \$30.3 million of non-capital losses which are available for carry forward to reduce future taxable income in future years. These losses expire between 2026 and 2030.

8. Share capital:

(a) Authorized:

Unlimited number of common shares without nominal or par value.

(b) Common shares issued and outstanding:

	Number of Shares	Amount
Balance, December 31, 2008	37,868,560	\$ 81,677,404
Issued pursuant to prospectus	9,000,000	11,250,000
Issued pursuant to flow-through private placement	1,071,500	1,500,100
Share issue costs	-	(973,244)
Tax effect of share issue costs	-	259,856
Balance, December 31, 2009	47,940,060	\$ 93,714,116
Issued pursuant to prospectus	26,000,000	65,000,000
Issued pursuant to prospectus	10,421,875	50,025,000
Exercise of performance options	750,000	750,000
Exercise of warrants	515,511	993,217
Exercise of stock options	2,043,000	3,773,083
Stock-based compensation on exercise of warrants, performance options and stock options	-	1,850,421
Share issue costs	-	(7,217,742)
Tax effect of share issue costs	-	1,869,395
Tax effect of flow-through shares issued in 2009	-	(375,025)
Balance, December 31, 2010	87,670,446	\$210,382,465

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Years ended December 31, 2010 and 2009

8. Share capital (continued):

(c) Warrants:

The Company had outstanding warrants that were issued to investors and agents, as commission, in certain equity financings. Each warrant is exercisable into one common share of the Company.

	Weighted average Exercise Price (\$)	Number of Warrants
Balance, at December 31, 2009 and 2008	1.93	586,631
Exercise of warrants	1.93	(515,511)
Expired	1.94	(71,120)
Balance, December 31, 2010	–	–

(d) Share purchase loan:

During the year ended December 31, 2010 the shareholder loan for \$100,000, due from an officer of the Company, was repaid in full. The loan was for the purchase of 40,000 common shares at a price of \$2.50 per common share.

(e) Stock options:

The Company's stock option plan provides for granting of options to directors and employees to a maximum of ten percent of the total issued and outstanding common shares of the Company. These options have a term of five years to expiry. Some of the options vest immediately, others vest one-third as of the date of grant, and one-third on each of the first two anniversary dates, and others vest one-third on each of the first three anniversary dates. The Company has reserved common shares for issuance under the stock option plan in the amount of the stock options outstanding from time to time.

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Years ended December 31, 2010 and 2009

8. Share capital (continued):

(e) Stock options (continued):

	2010		2009	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Stock options outstanding, beginning of year	4,671,166	\$ 2.01	3,638,500	\$ 2.27
Granted	5,834,000	4.57	1,183,500	1.30
Exercised	(2,043,000)	1.85	–	–
Forfeited	(71,666)	2.87	(150,834)	2.94
Stock options outstanding, end of year	8,390,500	\$ 3.82	4,671,166	\$ 2.01
Exercisable at year-end	2,342,000	\$ 2.12	2,854,166	\$ 2.12

Range of Exercise prices	Outstanding			Exercisable options	
	Number of options outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
\$1.00 – \$1.30	1,182,500	3.60	\$ 1.27	1,172,500	\$ 1.27
\$1.50 – \$2.02	509,833	1.96	1.67	376,666	1.67
\$2.50 – \$3.05	362,667	1.96	2.69	291,334	2.68
\$4.00 – \$5.17	6,335,500	4.32	4.54	501,500	4.11
Balance, end of year	8,390,500	3.98	\$ 3.82	2,342,000	\$ 2.12

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Years ended December 31, 2010 and 2009

8. Share capital (continued):

(f) Stock-based compensation:

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2010	2009
Fair value of options granted (\$/option)	\$ 3.14	\$ 0.95
Expected life of options (years)	5	5
Expected volatility (%)	92	95
Risk free rate of return (%)	2.55	2.62
Expected dividend yield (%)	Nil	Nil

(g) Performance options:

	2010	2009
Number outstanding	Nil	750,000
Exercisable	Nil	750,000
Weighted average remaining contractual life (years)	–	0.16
Weighted average exercise price (\$/share)	–	1.00

During the year ended December 31, 2010, 750,000 performance options exercisable at \$1.00 per performance option were exercised for total proceeds of \$750,000.

(h) Per share amounts:

The following table summarizes the basis for the determination of basic and diluted per share amounts:

	2010	2009
Weighted average number of shares – basic and diluted	70,306,119	39,502,345

In computing diluted per share amounts at December 31, 2010, 8,390,500 options (2009 – 4,671,166 options), nil performance options (2009 – 750,000 performance options), and nil warrants (2009 – 586,631 warrants) were excluded for the calculation as their effect was anti-dilutive.

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9. Contributed surplus:

	2010	2009
Balance, beginning of year	\$ 4,080,040	\$ 3,137,804
Stock-based compensation	3,856,382	942,236
Transfer to share capital on exercise of warrants and options	(1,850,421)	-
Balance, end of year	\$ 6,086,001	\$ 4,080,040

10. Related party transactions:

In conjunction with the equity issuance pursuant to the prospectus during the year ended December 31, 2010, certain officers and directors acquired 68,000 common shares at \$2.50 per share.

In conjunction with the equity issuance pursuant to the prospectus during the year ended December 31, 2009, certain officers and directors acquired 340,000 common shares at \$1.25 per share.

11. Financial instruments:

Overview

The Company has exposure to the following risks from its use of financial instruments:

- Credit risk
- Liquidity risk
- Market risk

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 has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board 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.

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Years ended December 31, 2010 and 2009

11. Financial instruments (continued):

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 venture partners and petroleum and natural gas marketers. As at December 31, 2010 the Company's receivables consisted of \$7.4 million (2009 - \$5.0 million) from joint venture partners, \$5.6 million (2009 - \$2.0 million) of receivables from petroleum and natural gas marketers and \$2.6 million (2009 - \$3.0 million) of other trade receivables.

Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company attempts to mitigate credit risk by establishing marketing relationships with a variety of purchasers. Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to the expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances is dependent on industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition, further risk exists with joint venture 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 venture partners; however the Company does have the ability to withhold production from joint venture partners in the event of non-payment.

The carrying amount of accounts receivable represents the maximum credit exposure. The Company has an allowance for doubtful accounts as at December 31, 2010 of \$0.1 million (2009 - \$0.1 million).

As at December 31, 2010 and 2009 the Company considers its receivables to be aged as follows:

Aging	2010	2009
Not past due (less than 120 days)	\$ 15,024,153	\$ 9,048,157
Past due (over 120 days)	585,534	963,612
Total	\$ 15,609,687	\$10,011,769

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Years ended December 31, 2010 and 2009

11. Financial instruments (continued):

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. To facilitate the capital expenditure program, the Company has a revolving reserve based credit facility, as outlined in note 5, that is at least reviewed annually by the lender. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month.

Accounts payable are considered due to suppliers in one year or less. Commodity contracts are also due to be settled with the respective counter-parties in one year at the estimated fair value on the balance sheet. Bank loans, which are subject to renewal after a 364-day revolving period, could be potentially due on May 31, 2012, if the Facilities are not renewed for the 364 day period, in which case the Facilities are converted to a one year term loan.

Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices, and interest rates will affect the Company's net income or the value of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns.

The Company utilizes financial derivative contracts to manage market risks. All such transactions are conducted in accordance with the risk management policy that has been approved by the Board of Directors.

Foreign currency exchange rate risk

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange risks. Although substantially all of the Company's petroleum and natural gas sales are denominated in Canadian dollars, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar.

The Company had no forward exchange rate contracts in place as at or during the years ended December 31, 2010 and 2009.

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Years ended December 31, 2010 and 2009

11. Financial instruments (continued):

Commodity price risk

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian and United States dollar, as outlined above, but also world economic events that dictate the levels of supply and demand.

During the year ended December 31, 2010 the Company entered into four costless collar financial oil contracts. The contracts are each for 500 barrels per day of oil with floor prices of \$70.00 per barrel Canadian. Two of the contracts have ceiling prices of \$100.00 per barrel Canadian and the other two contracts have ceiling prices of \$100.05 and \$100.30 per barrel Canadian, respectively. All contracts are for the period from January 1, 2011 to December 31, 2011. The Company recognized an unrealized loss of \$2,233,179 on the contracts as at and for the year ended December 31, 2010.

During the year ended December 31, 2009 the Company entered into a fixed price oil swap contract to receive \$64.40 per barrel in exchange for Canadian dollar WTI on oil production of 500 barrels per day for the period from April 1 to December 31, 2009. The Company realized a loss on the contract of \$1,439,613 for the year ended December 31, 2009.

The Company has assessed the sensitivity of the fair value of the oil commodity contracts to fluctuations in forward crude oil prices. As at December 31, 2010, if the forward price of crude had been \$1.00 higher, net income for the period would have been approximately \$547,500 lower, due to a higher unrealized loss on the commodity contracts. An equal and opposite impact would have occurred to net income had the forward price of crude been \$1.00 lower.

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 debt which bears a floating rate of interest. As at December 31, 2010, if interest rates had been one hundred basis points lower with all other variables held constant, net income for the year ended would have been approximately \$280,000 (2009 - \$268,000) higher due to lower interest expense. An equal and opposite impact would have occurred to net income had interest rates been one hundred basis points higher. The sensitivity is higher in 2010 as compared to 2009 because of an increase in outstanding bank debt and slightly higher interest rates.

The Company has no interest rate swap or financial contracts in place as at or during the years ended December 31, 2010 and 2009.

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Years ended December 31, 2010 and 2009

11. Financial instruments (continued):

Capital management

The Company's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain the future development of the business.

The Company manages its capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying petroleum and natural gas assets. The Company considers its capital structure to include shareholder's equity of \$209.2 million (2009 - \$95.5 million), bank debt of \$20.8 million (2009 - \$28.6 million) and a working capital deficiency excluding bank debt of \$27.8 million (2009 - \$6.2 million). In order to maintain or adjust the capital structure, the Company may from time to time issue shares and adjust its capital spending to manage current and projected debt levels.

The Company monitors capital based on the ratio of net debt to quarterly annualized funds from operations. In this ratio, net debt is defined as outstanding bank debt plus or minus working capital, divided by funds from operations for the most recent calendar quarter, annualized (multiplied by four). Funds from operations is defined as cash flow from operating activities before changes in non-cash working capital. The Company's strategy is to maintain a ratio of less than 2 to 1. This ratio may increase at certain times as a result of acquisitions. In order to facilitate the management of this ratio, the Company prepares annual capital expenditure budgets, which are updated as necessary depending on varying factors including current and forecast prices, successful capital deployment and general industry conditions. The annual and updated budgets are approved by the Board of Directors.

As at December 31, 2010 and 2009, the Company's ratio of net debt to quarterly annualized funds from operations was 1.6 to 1 and 13.0 to 1, respectively. The Company's ratio of net debt to quarterly annualized funds from operations at December 31, 2010 was within the 2 to 1 ratio that management targets to maintain. The Company issued \$86.3 million principal amount of convertible debentures subsequent to the end of the year (note 13) which was used to reduce bank debt levels through this debt instrument with a five year term.

The Company's bank completed its semi-annual borrowing base review on September 30, 2010 and the bank credit facility has been established at \$100 million. The next scheduled renewal is on or before May 31, 2011. The Company continually monitors its financing alternatives, and expects to finance its 2011 cash capital expenditures program from internally generated funds from operations, bank debt, and equity.

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Years ended December 31, 2010 and 2009

11. Financial instruments (continued):

The net debt to quarterly annualized funds from operations has been calculated as follows:

	2010	2009
Working capital deficiency (including bank debt)	\$ 48,592,380	\$ 34,778,672
Cash flow from operating activities	8,043,708	130,393
Change in non-cash operating working capital	(285,170)	537,141
Funds from operations	7,758,538	667,534
Annualizing factor	x4	x4
Annualized funds from operations	\$ 31,034,152	\$ 2,670,136
Ratio	1.6 to 1	13.0 to 1

The Company's share capital is not subject to external restrictions, however the bank debt facility is based on petroleum and natural gas reserves and a financial covenant (see note 5). The Company has not paid or declared any dividends since the date of incorporation, nor are any contemplated in the foreseeable future.

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

Fair value of financial instruments

The Company's financial instruments as at December 31, 2010 and 2009 includes accounts receivable, accounts payable and accrued liabilities, commodity contracts and bank debt. The fair value of accounts receivable and accounts payable and accrued liabilities approximate their carrying amounts due to their short-terms to maturity.

Bank debt bears interest at a floating market rate and accordingly the fair market value approximates the carrying value.

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Years ended December 31, 2010 and 2009

11. Financial instruments (continued):

The Company's financial instruments recorded at fair value require disclosure about how the fair value was determined based on significant levels of inputs described in the following hierarchy:

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

The Company's commodity contracts are the only financial instruments recorded at fair value as at December 31, 2010 and are considered level 2. The fair value of the commodity contracts are 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 volumes. As at December 31, 2010, the fair value of commodity contracts was determined using a forward price curve with a range of \$89.84 to \$93.75 per barrel of oil.

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Years ended December 31, 2010 and 2009

12. Commitments:

(a) Future minimum lease payments relating to office operating leases commitments are:

2011	\$ 737,984
2012	1,096,365
2013	1,096,365
2014	1,096,365
2015	1,096,365
2016	477,631

(b) As a requirement of a sublease for office premises, the Company has provided a letter of Guarantee in favour of the lessor as follows:

March 2010 to February 2011	\$ 60,000
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13. Subsequent events:

On February 14, 2011, Arcan issued \$86.3 million principal amount of 6.25% Convertible Unsecured Subordinated Debentures for net proceeds of \$82.4 million. The Debentures pay interest semi-annually on February 28 and August 31, commencing with the initial interest payment on August 31, 2011 and have a maturity date of February 28, 2016. The Debentures are convertible at the option of the holder to common shares at a conversion price of \$8.75 per common share. The Company has the option to redeem the Debentures on and after February 28, 2014 and at any time prior to February 28, 2016 at a redemption price equal to 100% of their principal amount plus accrued and unpaid interest provided that the current market price is at least 125% of the conversion price of \$8.75. On redemption or maturity the Company may elect to repay the principal and satisfy its interest obligations by issuing Arcan common shares.

Subsequent to December 31, 2010 the Company entered into two costless collar financial oil contracts. The contracts are each for 500 barrels per day of oil with floor prices of \$75.00 per barrel Canadian. One of the contracts has a ceiling price of \$126.00 per barrel Canadian and the other contract has a ceiling price of \$127.50 per barrel Canadian. Both contracts are for the period from January 1, 2012 to December 31, 2012.