

## AUDITORS' REPORT

To the Shareholders of Arcan Resources Ltd.

We have audited the balance sheets of Arcan Resources Ltd. as at December 31, 2006 and the statements of operations and deficit and cash flows for the six-month period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and the results of its operations and its cash flows for the six months ended December 31, 2006 in accordance with Canadian generally accepted accounting principles.

The financial statements as at June 30, 2006 and for the year then ended were audited by other auditors, who expressed an opinion without reservation on those statements in their report dated November 3, 2006.

(signed)  
KPMG LLP  
Chartered Accountants

Calgary, Alberta, Canada  
April 3, 2007

## MANAGEMENT'S REPORT

To the Shareholders of Arcan Resources Ltd.

Management is responsible for the preparation of the financial statements and for the consistency of all other financial and operating data presented in this annual report. Management maintains a system of internal controls to provide reasonable assurance that all assets are safeguarded and to facilitate the preparation of relevant, reliable and timely financial information.

Arcan's external auditors, KPMG LLP, Chartered Accountants, have audited the financial statements. The Audit Committee has reviewed the financial statements with management and the auditors and has recommended their approval to the Board of Directors. The Board of Directors has subsequently approved the financial statements.

(signed)  
Ed Gilmet  
President and CEO

(signed)  
Douglas N. Penner  
CFO and V.P. Finance

Calgary, Alberta, Canada  
April 3, 2007

# Arcan Resources Ltd.

## Balance Sheets

As at December 31, 2006 and June 30, 2006

	December 31, 2006	June 30, 2006
<b>ASSETS</b>		
Current assets		
Cash	\$ -	\$ 14,936,785
Accounts receivable	13,864,690	8,298,897
	<b>13,864,690</b>	23,235,682
Property, plant and equipment (note 4)	68,153,872	34,618,693
	<b>\$ 82,018,562</b>	<b>\$ 57,854,375</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 18,107,588	\$ 12,907,955
Bank loan (note 5)	11,502,221	-
	<b>29,609,809</b>	12,907,955
Asset retirement obligations (note 6)	3,268,469	710,880
Future income taxes (note 7)	1,009,916	1,183,572
	<b>33,888,194</b>	14,802,407
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (note 8)	49,047,817	44,028,648
Share purchase loan (note 8(e))	(100,000)	(100,000)
Contributed surplus (note 9)	1,757,255	1,379,779
Deficit	(2,574,704)	(2,256,459)
	<b>48,130,368</b>	43,051,968
	<b>\$ 82,018,562</b>	<b>\$ 57,854,375</b>

Commitments (note 11)

Subsequent events (note 13)

See accompanying notes to Financial Statements

Approved by the Board of Directors:

Ed Gilmet

Director

Andy Fisher

Director

## Arcan Resources Ltd.

### Statements of Operations and Deficit

For the six months ended December 31, 2006 and the year ended June 30, 2006

	December 31, 2006	June 30, 2006
<b>REVENUES</b>		
Petroleum and natural gas	\$ 6,303,893	\$ 6,698,785
Interest and other revenue	77,497	178,881
Royalties	(1,437,450)	(1,753,002)
	<b>4,943,940</b>	<b>5,124,664</b>
<b>EXPENSES</b>		
Operating	790,876	691,339
General and administrative	1,351,960	1,096,955
Stock-based compensation (note 8)	377,476	1,019,872
Interest	112,548	-
Accretion (note 6)	92,511	18,263
Depletion and depreciation	2,706,107	4,115,091
	<b>5,431,478</b>	<b>6,941,520</b>
Loss before income taxes	(487,538)	(1,816,856)
Future income tax reduction (note 7)	169,293	253,465
<b>NET LOSS FOR THE PERIOD</b>	<b>(318,245)</b>	<b>(1,563,391)</b>
Deficit, beginning of period	(2,256,459)	(693,068)
<b>Deficit, end of period</b>	<b>\$ (2,574,704)</b>	<b>\$ (2,256,459)</b>
Net loss per share (note 8)		
Basic	\$ (0.01)	\$ (0.11)
Diluted	\$ (0.01)	\$ (0.11)

See accompanying notes to Financial Statements

**Arcan Resources Ltd.**  
**Statements of Cash Flows**

For the six months ended December 31, 2006 and the year ended June 30, 2006

	December 31, 2006	June 30, 2006
Cash provided by (used in):		
<b>OPERATING</b>		
Net loss for the period	\$ (318,245)	\$ (1,563,391)
Add (deduct) items not affecting cash:		
Depletion and depreciation	2,706,107	4,115,091
Stock-based compensation	377,476	1,019,872
Accretion	92,511	18,263
Future income tax reduction	(169,293)	(253,465)
	<b>2,688,556</b>	<b>3,336,370</b>
Change in non-cash working capital	<b>(341,046)</b>	<b>(454,680)</b>
	<b>2,347,510</b>	<b>2,881,690</b>
<b>FINANCING</b>		
Bank loan	11,502,221	-
Issue of common shares, net of costs	5,014,806	41,187,229
	<b>16,517,027</b>	<b>41,187,229</b>
<b>INVESTING</b>		
Property, plant and equipment	(24,186,931)	(25,292,316)
Acquisition of property, plant and equipment	(9,589,277)	(8,856,949)
Change in non-cash working capital	(25,114)	4,887,713
	<b>(33,801,322)</b>	<b>(29,261,552)</b>
<b>Increase (decrease) in period</b>	<b>(14,936,785)</b>	<b>14,807,367</b>
Cash, beginning of period	14,936,785	129,418
<b>Cash, end of period</b>	<b>\$ -</b>	<b>\$14,936,785</b>
Supplementary disclosure:		
Interest paid	\$ 112,548	\$ 1,997
Taxes paid	\$ -	\$ -
Cash is defined as cash and cash equivalents:		
Cash in bank	\$ -	\$ 436,785
Term deposits	-	14,500,000
	<b>\$ -</b>	<b>\$14,936,785</b>

See accompanying notes to Financial Statements

# **Arcan Resources Ltd.**

## **Notes to the Interim Financial Statements**

For the six months ended December 31, 2006 and the year ended June 30, 2006

### **Note 1 Basis of presentation**

Arcan Resources Ltd. ("Arcan" or "the Company") is a private company incorporated under the Business Corporations Act (Alberta). Arcan is involved in the business of oil and natural gas exploration, development and production in Canada.

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. 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.

### **Note 2 Significant Accounting Policies**

#### **(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.

## **Arcan Resources Ltd.**

### **Notes to the Interim Financial Statements**

For the six months ended December 31, 2006 and the year ended June 30, 2006

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

Costs of 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 that 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 basis rate of 30% and 20% respectively per annum.

#### **(b) Interests in joint operations**

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

## **Arcan Resources Ltd.**

### **Notes to the Interim Financial Statements**

For the six months ended December 31, 2006 and the year ended June 30, 2006

#### (d) Asset retirement obligations

The Company uses the asset retirement obligations 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 obligations. Actual costs incurred upon settlement of the retirement obligations are charged against the obligation to the extent of the liability recorded.

#### (e) 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.

#### (f) 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.

#### (g) 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 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.

## **Arcan Resources Ltd.**

### **Notes to the Interim Financial Statements**

For the six months ended December 31, 2006 and the year ended June 30, 2006

(h) Revenue recognition

Petroleum and natural gas revenues are recognized when the title and risks pass to the purchaser.

(i) Per share amounts

Basic per share information is computed by dividing net 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.

#### **Note 3      Acquisition**

On September 28, 2005, the Company executed a Purchase and Sale Agreement (the "Agreement") for the purchase of an 11% interest in certain lands and petroleum and natural gas rights, wells and facilities in the Deer Mountain Unit No. 2 (the "Unit") for net cash consideration of \$1.8 million. The earnings from this acquisition are included in the Company's Statement of Operations from September 28, 2005 onwards. In October 2005, the Company sold a 0.5% Unit interest for cash consideration of \$88,000 to a company owned by the President and CEO of Arcan (the "Purchaser"). The Company has the option to repurchase the 0.5% Unit interest for a period of 30 months for \$88,000 plus any additional costs or charges incurred by the Purchaser, less any related cash flow accruing to the Purchaser.

On August 25, 2006 the Company purchased an additional 65.4% of the Unit for \$9.6 million pursuant to a September 2005 Participation and Option to Purchase Agreement. The earnings from this acquisition are included in the Company's Statement of Operations from August 25, 2006 onwards.

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

The acquisition of the 65.4% interest in the Unit was accounted for by the purchase method, with the assets and liabilities recorded at cost as follows:

Net assets acquired:	\$
Oil and natural gas properties, plant and equipment	11,906,616
Asset retirement obligations	(2,317,339)
Total consideration paid in cash	9,589,277

The above amounts are estimates made by management based on currently available information. Amendments may be made to the purchase equation as the balances are finalized.

#### Note 4 Property, plant and equipment

\$	December 31, 2006	June 30, 2006
Oil and natural gas properties, plant and equipment	73,425,229	37,593,119
Office equipment and computers	1,587,841	1,178,665
	75,013,070	38,771,784
Less accumulated depletion and depreciation	(6,859,198)	(4,153,091)
	68,153,872	34,618,693

At December 31, 2006, oil and natural gas properties included undeveloped properties of \$4.6 million (June 2006 – \$13.2 million), which have been excluded from the depletion calculation. Future development costs of proved reserves of \$21.7 million (June 2006 - \$20.9 million) have been included in the depletion calculation.

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

The Company applied the ceiling test to its capitalized assets at December 31, 2006 and determined that there was no impairment of costs requiring a write-down. For the purposes of the December 31, 2006 impairment test of petroleum and natural gas properties, the following benchmark prices were used:

Year	Oil	Gas
	WTI - \$US	AECO - \$CDN
2007	62.00	7.20
2008	60.00	7.45
2009	58.00	7.75
2010	57.00	7.80
2011	57.00	7.85
2012	57.50	8.15
2013+	+2.0%/year	+2.0%/year

#### Note 5 Bank loan

	December 31, 2006	June 30, 2006
\$		
Bank loan	<b>11,502,221</b>	-

Arcan has a \$20 million operating revolving loan facility. Interest on the facility is calculated at the bank prime rate of interest, plus an applicable facility margin that will be either 0.20% or 0.40%, depending upon the Company's Net Debt to Trailing Cash Flow ratio. If this ratio is less than or equal to 1.25:1, the interest will be calculated at the prime rate of interest plus 0.20 percent, and if this ratio is greater than 1.25:1, the interest will be calculated at the prime rate of interest plus 0.40 percent. A re-determination of the borrowing base will occur on or before April 30, 2007. The loan facility is secured by a general security agreement, and is payable in full on demand.

# Arcan Resources Ltd.

## Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

### Note 6 Asset retirement obligations

	Six months ended December 31, 2006	Year ended June 30, 2006
\$		
Balance - beginning of period	710,880	52,295
Liabilities incurred	147,739	549,446
Liabilities acquired (note 2)	2,317,339	90,876
Accretion	92,511	18,263
Balance - end of period	3,268,469	710,880

The Company's asset retirement obligations result from net ownerships 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 is \$8.4 million (June 30, 2006 - \$1.5 million), which will be incurred between 2006 and 2019. The majority of the costs will be incurred between 2010 and 2016. An inflation rate of 2.0% was used to inflate the costs, and a credit-adjusted risk-free rate of 8.0% was used to calculate the fair value of the asset retirement obligations.

### Note 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:

	Six months ended December 31, 2006	Year ended June 30, 2006
\$		
Combined federal and provincial statutory rate	34.50%	16.12%
Expected future income tax recovery	(168,201)	(292,877)
Non-deductible crown payments (net of provincial credits)	68,064	107,750
Stock-based compensation	130,229	164,403
Resource allowance	(76,126)	(76,626)
Future tax rate increase	(65,016)	(145,296)
Change in valuation allowance	-	(16,214)
Other	(58,243)	5,395
Future income tax reduction	(169,293)	(253,465)

# Arcan Resources Ltd.

## Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

Arcan is classified as a Canadian Controlled Private Company, which entitles it to the Small Business Deduction to reduce its income taxes. Because Arcan is intending to become a public company (note 13), it has increased its future tax rate.

The components of the future income taxes are as follows:

\$	December 31, 2006	June 30, 2006
Share issue costs	497,466	585,608
Asset retirement obligations	971,324	223,700
Net book value of assets in excess of tax basis	(2,478,706)	(1,992,880)
Future income taxes	(1,009,916)	(1,183,572)

### Note 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, at June 30, 2005	4,920,545	4,250,847
Common shares issued <sup>(i)</sup>	5,187,600	8,300,160
Flow-through shares issued <sup>(i)</sup>	3,228,400	5,972,540
Tax effect of flow-through shares	-	(2,143,523)
Warrants exercised	5,560	8,896
Common shares issued <sup>(ii)</sup>	6,800,000	17,000,000
Common shares issued <sup>(iii)</sup>	4,400,000	12,100,000
Share issue expenses	-	(2,166,758)
Tax effect of share issue expenses	-	706,486
Balance, at June 30, 2006	24,542,105	44,028,648
Common shares issued <sup>(iv)</sup>	315,492	-
Common shares issued <sup>(v)</sup>	838,224	2,347,027
Flow-through shares issued <sup>(v)</sup>	838,224	2,682,317
Share issue expenses	-	(14,538)
Tax effect of share issue expenses	-	4,363
Balance, at December 31, 2006	26,534,045	49,047,817

## **Arcan Resources Ltd.**

### **Notes to the Interim Financial Statements**

For the six months ended December 31, 2006 and the year ended June 30, 2006

(i) On July 19, 2005, the Company completed a private placement of common shares at \$1.60/share, together with flow-through shares at \$1.85/share. This issue included 406,440 warrants.

(ii) On April 27, 2006, the Company completed a private placement at \$2.50/share.

(iii) On May 26, 2006, the Company completed a private placement at \$2.75/share.

(iv) Pursuant to the terms of an Agency Agreement dated July 30, 2004, under which the Company issued 514,920 flow-through shares and 2,640,000 units comprised of one common share and 0.2 of a warrant, subscribers received one right for each flow-through share and unit subscribed for. Each right entitles the holder to be issued an additional 0.10 common share, for no additional consideration or further action on the part of the holder, in the event that a liquidity event has not occurred by July 30, 2006. The liquidity event did not occur by July 30, 2006, so the Company issued 315,492 common shares for no additional consideration.

(v) On November 3, 2006, the Company completed a private placement of 838,224 units at \$6.00 per unit for gross proceeds of \$5,029,344. Each unit was comprised of one common share at \$2.80 per share, together with one flow-through share at \$3.20 per share. The Company has until December 31, 2007 to incur \$2,682,317 of qualifying flow-through expenditures which will be renounced to the investors. Directors and Officers of the Company purchased 426,934 units or \$2,561,604 of the private placement.

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

(c) Warrants

	Weighted average exercise price (\$)	Number of Warrants
Agent warrants <sup>(i)</sup>	1.00	236,619
Private placement – common shares (note 8 (b)(iii))	2.00	528,000
Private placement – flow-through shares (note 8(b)(iv)) <sup>(ii)</sup>	1.60	122,311
Balance, at June 30, 2005	1.68	886,930
Warrants issued <sup>(iii)</sup>	1.60	406,440
Exercise of warrants	1.60	(5,560)
Balance, at June 30, 2006 and December 31, 2006	1.65	1,287,810

(i) Pursuant to an Agency Agreement dated July 30, 2004 for the private placements described in notes 7(b)(iii) and (iv), the Company granted the agent 236,619 warrants for the purchase of 236,619 common shares of the Company. The warrants are exercisable at \$1.00 per share, are fully vested on issuance and expire twelve months from the date the Company becomes a public company or a liquidity event occurs.

(ii) In July 2005, all subscribers to the April 2005 private placement accepted the Company's request to reduce the warrant exercise price from \$3.00 per share to \$1.60 per share on all of the 122,311 warrants issued as part of the units. The weighted average exercise price for the opening balance of warrants outstanding as at June 30, 2005 has been adjusted to reflect the price reduction of the April 2005 warrants. The fair value of the warrants repriced has been estimated at \$11,219 using the Black-Scholes Pricing Model based on the following assumptions: zero dividend yield, expected volatility of 1% as permitted for private companies, risk-free interest rate of 3.3% and expected life of 1.8 years. As the warrants vest immediately, the entire fair value was recognized as current period share issue expenses, with a corresponding increase in contributed surplus.

(iii) The fair value of the warrants issued has been estimated at \$61,172 using the Black-Scholes Pricing Model based on the following assumptions: zero dividend yield, expected volatility of 1% as permitted for private companies, risk-free interest rate of 3.3% and expected life of three years. As the warrants vest immediately, the entire fair value was recognized as current period share issue expenses, with a corresponding increase in contributed surplus.

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

	Exercise price (\$)	Number of Warrants
Issued July 2004 - expire 12 months after going public	2.00	528,000
Issued July 2004 - expire 12 months after going public	1.00	236,619
Issued April 2005 - expire 6 months after going public	1.60	116,751
Issued July 2005 - expire 12 months after going public	1.60	406,440
	1.65	1,287,810

(d) Flow-through shares

The related tax benefits of \$6,522,940 of flow-through share proceeds raised in April and July 2005 were renounced to investors in February 2006 with an effective date of December 31, 2005. The Company had until December 31, 2006 to incur \$5,972,540 of qualifying flow-through expenditures, all of which had been spent as at June 30, 2006. The future income tax effect of the flow-through share proceeds has been recorded.

Pursuant to the private placement which closed on November 3, 2006, the Company issued 838,224 flow-through common shares for gross proceeds of \$2,682,317. The Company renounced \$2,682,317 to the investors, effective December 31, 2006. The Company has incurred \$1,934,455 to December 31, 2006 and has until December 31, 2007 to expend \$747,862 on qualified expenditures.

(e) Share purchase loan

A share purchase loan of \$100,000 (June 2006 - \$100,000) is due from an officer of the Company for the purchase of 40,000 (June 2006 - 40,000) common shares at a price of \$2.50 per common share. This loan is repayable, with interest calculated at the "Prescribed Rate" as determined by the Canada Revenue Agency, currently 5%, on or before April 3, 2009. This loan is secured by the underlying shares. Stock based compensation of \$11,716 was charged to income and contributed surplus for the loan.

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

(f) Per share amounts

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

	<b>Six months ended December 31, 2006</b>	Year ended June 30, 2006
Weighted average common shares outstanding - basic	<b>25,294,604</b>	14,507,604
Weighted average common shares outstanding - diluted	<b>25,294,604</b>	14,507,604

In computing diluted per share amounts at December 31, 2006, 2,483,500 (June 30, 2006 - 2,263,500) options, 1,500,000 (June 30, 2006 - 1,500,000) performance options, and 1,287,810 (June 30, 2006 - 1,287,810) warrants were excluded from the calculation as their effect was anti-dilutive.

(g) Stock-based compensation

The Company has a stock option plan that is described below. Compensation costs attributable to share options granted to employees or directors are measured at fair value at the grant date and expensed to stock-based compensation expense over the expected vesting time frame with a corresponding increase to contributed surplus. 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:

Six months ended December 31,	<b>2006</b>	2005
Fair value of options granted (\$/option)	<b>0.98</b>	0.45
Expected life of options (years)	<b>10</b>	10
Expected volatility (%)	<b>—</b>	—
Risk free rate of return (%)	<b>4.2</b>	3.3
Expected dividend yield (%)	<b>Nil</b>	Nil

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

(g) Stock-based compensation, continued

The Company's stock option plan provides for granting of options to directors, employees and consultants to a maximum of ten percent of the total issued and outstanding common shares of the Company. These options have a term of ten years to expiry. Some of the options vest immediately, while others vest one-third as of the date of grant, and one-third on each of the first two 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.

	Six months ended December 31, 2006		Year ended June 30, 2006	
	Number of options	Weighted average exercise price (\$/share)	Number of options	Weighted average exercise price (\$/share)
Balance, beginning of period	2,263,500	1.87	462,500	1.00
Granted	220,000	2.75	1,801,000	2.10
Balance, end of period	2,483,500	1.95	2,263,500	1.87
Exercisable, end of period	1,676,833	1.68	1,576,833	1.61

	Outstanding options			Exercisable options	
Exercise price (\$/share)	Number of options outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price (\$/share)	Number of options exercisable	Weighted average exercise price (\$/share)
1.00	462,500	7.98	1.00	462,500	1.00
1.60	871,000	8.85	1.60	804,333	1.60
2.50 - 2.75	1,150,000	9.47	2.60	410,000	2.61
Balance, end of period	2,483,500	8.98	1.95	1,676,833	1.68

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

(h) Performance options	December 31, 2006	June 30, 2006
Number outstanding	1,500,000	1,500,000
Exercisable	-	-
Weighted average remaining contractual life (years)	2.75	8.26
Weighted average exercise price (\$/share)	1.00	1.00

In May 2004 and March 2005, the Company granted a total of 1,500,000 performance options (750,000 on each date) at an exercise price of \$1.00 per share to two officers who are also directors of the Company. The options expire 5 years from the grant date. In November 2005, the Company's Board of Directors approved the following amendments to performance options with an effective date of September 15, 2005:

The performance options may only be exercised if one of the following liquidity events has occurred:

- (i) The Company's shares are listed for trading on a Canadian Stock Exchange, or
- (ii) The Company's Board of Directors and shareholders have approved:
  - (a) The sale, exchange or arrangement of all of the Company's common shares, or
  - (b) The sale of all or substantially all of the assets of the Company.

Holders of performance options may exercise their options in the following percentages at the following price thresholds:

- (i) 30% at the initial threshold of \$2.00 per share
- (ii) an additional 15% at a price of \$2.35 per share
- (iii) an additional 15% at a price of \$2.60 per share
- (iv) an additional 15% at a price of \$2.85 per share
- (v) the final 25% at a price of \$3.20 per share

The fair value of these performance options of \$420,680 is recorded to income and contributed surplus over the option's vesting term.

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

#### Note 9 Contributed surplus

	Six months ended December 31, 2006	Year ended June 30, 2006
\$		
Balance, beginning of period	1,379,779	287,516
Stock-based compensation	377,476	1,019,872
Fair value of broker warrants (note 7 (c))	-	72,391
Balance, end of period	1,757,255	1,379,779

#### Note 10 Related party transactions

The following transactions with related parties were recorded at the exchange amount.

Included in general and administrative expenses, share issue costs, and capitalized deal costs for the six months ended December 31, 2006 are amounts totaling \$328,526 (year ended June 30, 2006 – \$198,973) charged to the Company by a legal firm at which a director and officer of the Company is a partner. As of December 31, 2006, \$267,164 (June 30, 2006 - \$63,826) was in accounts payable.

Included in property, plant, and equipment for the six months ended December 31, 2006 are amounts totaling \$4,341,126 (year ended June 30, 2006 – \$6,345,664) charged to the Company by an oil and gas service entity at which a director of the Company is a director and officer. As of December 31, 2006, \$854,749 (June 30, 2006 - \$1,228,279) was in accounts payable.

In October 2005, the Company sold a 0.5% Unit interest for cash consideration of \$88,000 to a company owned by the President and CEO of Arcan (the "Purchaser"). The Company has the option to repurchase the 0.5% Unit interest for a period of 30 months for \$88,000 plus any additional costs or charges incurred by the Purchaser, less any related cash flow accruing to the Purchaser.

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

The Company is the operator of a property in which a corporation had a working interest which was being held in trust for another corporation related through common shareholdings. Amounts charged by the Company, under the same terms and conditions as third party joint venture partners, totaled \$99,865 of capital expenditures (year ended June 30, 2006 – \$53,549) and \$16,998 of net revenue (year ended June 30, 2006 – \$20,117), for the six months ended December 31, 2006. As at December 31, 2006, included in accounts receivable was \$116,468 (June 30, 2006 – \$33,601) in respect of the above amounts.

The Company is the operator of a property in which a corporation, related through common shareholdings, is a joint venture partner. Amounts charged by the Company, under the same terms and conditions as third party joint venture partners, totaled \$1,879,751 of capital expenditures (year ended June 30, 2006 - \$2,797,071) and \$364,869 of net revenue for the six months ended December 31, 2006 (year ended June 30, 2006 - \$377,107). As at December 31, 2006, included in accounts receivable was \$1,670,126 (June 30, 2006 – \$nil), and included in accounts payable was \$809,754 (June 30, 2006 - \$711,854), in respect of the above amounts.

A share purchase loan of \$100,000 (June 2006 - \$100,000) is due from an officer of the Company for the purchase of 40,000 (June 2006 – 40,000) common shares at a price of \$2.50 per common share. This loan is repayable, with interest calculated at the "Prescribed Rate" as determined by the Canada Revenue Agency, currently 5%, on or before April 3, 2009. This loan is secured by the underlying shares.

#### Note 11 Commitments

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

To December 31,	\$
2007	229,500
2008	238,500
2009	238,500
2010	238,500
2011	244,125
Remainder to 2016	1,123,875

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

- (b) As a requirement of a sublease for office premises, the Company has provided a letter of Guarantee in favour of the lessor for a five year period on a declining basis as follows:

	\$
February 2006 to February 2007	300,000
March 2007 to February 2008	240,000
March 2008 to February 2009	180,000
March 2009 to February 2010	120,000
March 2010 to February 2011	60,000

#### Note 12 Financial instruments

The Company's financial instruments recognized in the balance sheet consist of accounts receivable, accounts payable and accrued liabilities, and bank loan.

The carrying values of the Company's financial instruments approximate their fair market values due to their demand nature or relatively short periods to maturity. The Company's bank loan is subject to floating interest rates.

The Company is exposed to foreign currency fluctuations as oil and natural gas prices received are referenced to U.S. dollar denominated prices.

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

The Company is exposed to interest rate risk to the extent that the bank loan is at a floating rate of interest.

## Arcan Resources Ltd.

### Notes to the Interim Financial Statements

For the six months ended December 31, 2006 and the year ended June 30, 2006

#### Note 13 Subsequent events

(a) Arcan entered into an amalgamation agreement dated October 11, 2006 providing for a reverse take-over (the "RTO" or the "Amalgamation") of Desco Energy Ltd. by Arcan. Upon completion of the Amalgamation the name of the amalgamated corporation ("Amalco") will be "Arcan Resources Ltd."

Pursuant to the Amalgamation Agreement, each common share of Desco will be converted into 0.36231884 of an Amalco Share, together with one Amalco Performance Share. Certain founding shareholders of Desco have agreed to cancel 2,349,600 of their common shares of Desco for nil proceeds in connection with the Amalgamation.

Each Amalco Performance Share will, on or before November 1, 2008, be either redeemed and cancelled or converted into a fraction of an Amalco Share. In the event that the total proved and probable reserves attributed to certain properties held by Amalco and located in the Hamburg area of Alberta effective June 30, 2008 are determined by an independent firm of qualified oil and natural gas reserves evaluators to be less than 2,216,466 barrels of oil equivalent ("BOE") the Amalco Performance Shares will not be converted into Amalco Shares and will be redeemed and cancelled by Amalco. If the reserves attributable to the Hamburg properties are determined to be equal to or greater than 2,216,466 BOE but less than 3,324,700 BOE, each Amalco Performance Share shall convert into 0.13175241 of an Amalco Share and, if determined to be equal to or greater than 3,324,700 BOE each Amalco Performance Share shall convert into 0.20380435 of an Amalco Share.

Arcan expects that, at closing, Amalco will issue a total of 2,373,333 common shares of Amalco in exchange for the common shares of Desco, calculated as follows:

Desco common shares outstanding, per their June 30, 2006 Interim Report	8,338,600
Desco options outstanding, per their June 30, 2006 Interim Report	861,400
Desco options to be cancelled, per the Amalgamation Agreement	(300,000)
Desco common shares to be cancelled, per the Amalgamation Agreement	(2,349,600)
	6,550,400
Exchange ratio, per the Amalgamation Agreement	0.36231884
	2,373,333

## **Arcan Resources Ltd.**

### **Notes to the Interim Financial Statements**

For the six months ended December 31, 2006 and the year ended June 30, 2006

In addition, pursuant to the Amalgamation Agreement, each common share of Arcan will be converted into one Amalco Share and each outstanding stock option, warrant and performance warrant of Arcan was converted into one corresponding convertible security in Amalco.

The Amalgamation was approved by the requisite majorities of the shareholders of each of Arcan and Desco at special shareholder meetings held on December 29, 2006, and closed on January 1, 2007.

Pursuant to the rules of the TSX Venture stock exchange, the employee stock option plan was amended to reduce the term of the stock options from ten years from their initial grant to five years from the date of amalgamation. The performance option term was reduced from ten years from the date of initial grant to five years from the date of initial grant.

# **Arcan Resources Ltd.**

## **Corporate Information**

### **Directors**

M. Bruce Chernoff

Chairman of Harvest Operations Corp.

Robert J. Dales

Director, Celtic Exploration Ltd.

Andy Fisher

Executive Vice President, Arcan Resources Ltd.

Ed Gilmet

President and CEO, Arcan Resources Ltd.

Michael J. Laffin

Partner, Blake, Cassels & Graydon LLP

J. Terry McCoy

President, Trafina Energy Ltd.

Hank B. Swartout

Chairman and CEO - Precision Drilling Corporation

### **Auditors**

KPMG LLP

### **Evaluation Engineers**

GLJ Petroleum Consultants Ltd.

### **Banker**

Alberta Treasury Branches

### **Legal Counsel**

Blake, Cassels & Graydon LLP

### **Officers**

Ed Gilmet

President and CEO

Andy Fisher

Executive Vice President

Doug Penner

CFO and V.P. Finance

Graeme Ryder

Controller

Michael J. Laffin

Corporate Secretary

### **Corporate Office**

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(403) 262-0321

### **Registrar and Transfer Agent**

Valiant Trust Company

### **Stock Exchange Listing**

TSX-V (symbol "ARN")

### **Investor Relations Contact**

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