

Management's Discussion and Analysis

Arcan is engaged in the exploration for, and the development and production of, petroleum and natural gas in Western Canada. Arcan was incorporated on October 9, 2003, and had a fiscal year end of June 30. Arcan amalgamated with Desco Energy Ltd. ("Desco") on January 1, 2007 and Arcan's year end was changed to December 31.

This Management's Discussion & Analysis ("MD&A") is dated April 3, 2007, and is an explanation, through the eyes of management, of how Arcan performed during the period covered by the financial statements, and of Arcan's financial condition and future prospects. MD&A complements and supplements the financial statements of Arcan, and should be read in conjunction with the audited financial statements for the six months ended December 31, 2006 and the year ended June 30, 2006, together with the notes related thereto. The reader is also referred to the joint management information circular dated November 28, 2006. These documents are available at www.sedar.com. The financial statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") in Canadian dollars. Readers should read the legal advisories at the end of this MD&A.

Highlights	Six months ended December 31, 2006	Year ended June 30, 2006	Year ended June 30, 2005
Financial (\$000's, except shares and per share amounts)			
Oil and natural gas revenues	6,304	6,699	95
Cash provided by (used in) operating activities	2,348	2,882	(335)
Funds flow from operations ⁽¹⁾	2,689	3,336	(351)
Per share – basic ⁽¹⁾	0.11	0.23	(0.08)
Net loss	(318)	(1,563)	(612)
Per share – basic and diluted	(0.01)	(0.11)	(0.14)
Total assets	82,019	57,854	4,964
Bank loan	11,502	-	-
Shareholders' equity	48,130	43,052	3,845
Capital expenditures	33,776	34,149	3,798
Common shares outstanding	26,534,045	24,542,105	4,920,545
Weighted average - basic	25,294,604	14,507,604	4,318,164
Weighted average - diluted	25,294,604	14,507,604	4,318,164
Sales Volumes			
Crude oil and NGL's (bbls per day)	373	127	1
Natural gas (mcf per day)	1,377	1,209	30
Barrels of oil equivalent (boe per day) ⁽²⁾	603	329	6

(1) The reader is referred to the section - "Non-GAAP Measurements".

(2) The reader is referred to the section - "Oil, Natural Gas Liquids and Natural Gas Conversions to BOE's".

Overview

Arcan continues to execute its strategy of pursuing internally generated exploration and development prospects in its core areas. The focus is on growth through the drill bit. Accretive acquisitions are constantly being evaluated with the goal of buying upside potential, not production additions. Arcan is the operator of its three core oil and natural gas properties, all of which are located in West Central and Northwest Alberta. Arcan maintains and enhances concentrated high working interest assets which are intended to generate stable production profiles and long life reserves.

Arcan is engaged in a substantial capital expenditure program with plans to develop its three core oil and natural gas properties to their full potential. Arcan expended \$33.4 million on its properties during the six months ended December 31, 2006 compared to \$34.2 million during the year ended June 30, 2006.

During the three months period ended December 31, 2006, Arcan drilled eight (6.0 net) wells, which resulted in four (2.8 net) oil wells, two (1.7 net) gas wells, one (0.8 net) standing well, and one (0.8 net) water injector well.

During the three months ended March 31, 2007 Arcan drilled six wells (4.1 net). Of these wells one (0.3 net) was drilled in McLeod, one (0.8 net) was drilling in Deer Mountain, and 4 (3.0 net) were drilled in Hamburg. At March 31, 2007 Arcan was producing approximately 2,000 boe per day.

The Amalgamation with Desco Energy Ltd. was approved by the shareholders of each company on December 29, 2006, made effective on January 1, 2007, and has resulted in Arcan becoming a public company with its shares trading on the TSX Venture Exchange under the symbol 'ARN' beginning on January 9, 2007. This is expected to provide Arcan with additional access to public equity markets, and will provide Arcan Shareholders with the liquidity of a public market. Desco's properties consist of working interests in the Hamburg and McLeod properties that are already operated by Arcan, so this fits with Arcan's long term strategy of acquiring and developing concentrated, high working interest operated assets. At December 31, 2006 Arcan had 14 full time employees.

Results of Operations

Sales Volumes	Three months		Six Months	Year
	December	June	December	June
	2006	2006	2006	2006
Crude oil and NGL's (bbls per day)	531	268	373	127
Natural gas (mcf per day)	1,466	1,908	1,377	1,209
Total oil equivalent (boe per day)	775	586	603	329
Oil as a % of total volumes	68%	46%	62%	39%

Arcan's initial drilling success in its three core oil and gas fields this year is reflected in its growing sales volumes. Arcan has a substantial inventory of development wells to drill to offset its exploration success, and to further develop the Deer Mountain Unit. In addition, Arcan expects that new exploration prospects will be drilled. Arcan plans to continue to explore, develop and exploit its core areas in the coming years, and anticipates that its sales volumes will steadily grow.

Net Loss and Funds Flow From Operations

	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Net loss	(131,470)	(756,424)	(318,245)	(1,563,391)
Per share	(0.01)	(0.04)	(0.01)	(0.11)
Funds flow from operations	1,628,770	1,364,039	2,688,556	3,336,370
Per share	0.06	0.07	0.11	0.23

Definition of "Funds flow from operations"

	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Cash provided by operating activities	1,186,306	184,353	2,347,510	2,881,690
Change in non-cash working capital	(442,464)	(1,179,686)	(341,046)	(454,680)
Funds flow from operations	1,628,770	1,364,039	2,688,556	3,336,370

Arcan is generating funds from the operations of its three core properties. A net loss has been realized due to stock based compensation and depletion, depreciation, and accretion charges. As Arcan continues to develop these properties, it anticipates that additional revenues will be generated resulting in increased funds flow as well as net earnings.

Petroleum and Natural Gas Revenues

	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Oil and liquids	3,046,086	1,870,398	4,532,795	3,160,391
Per barrel	63.02	76.64	66.00	68.09
Natural gas	995,419	1,170,306	1,771,098	3,538,394
Per mcf	7.46	6.74	6.99	8.02
Oil and liquids as a % of total revenue	75%	62%	72%	47%

Arcan's revenues for the period ended December 31, 2006 were down over the year ended June 30, 2006 revenues. This is due to the December period only including six months of operations compared to the June periods including a full year. On an equivalent time basis, revenues are up due to increased production volumes offset by slightly lower prices for both oil and natural gas. Oil continues to grow as a percent of Arcan's total revenues as Arcan invests in increasing its oil production. Arcan revenues were up on sales volume increases primarily from Arcan's Deer Mountain area.

Royalty Expense	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Royalties, net of ARTC	977,723	740,781	1,437,450	1,753,002
Per boe	13.86	13.89	12.96	14.61
Royalties as a % of revenue	24.2%	24.4%	22.8%	26.2%

Royalty rates fluctuate with the price of oil and gas and also when higher rates of production are experienced. The increase in the royalty rate is due to a well being on a royalty holiday in the first quarter of the prior year. The Alberta Government has announced that the Alberta Royalty Tax Credit ("ARTC") is expected to be eliminated effective January 1, 2007. This will have the effect of increasing Arcan's future royalty rate. Arcan anticipates that its ongoing royalty rate will be approximately 25 to 30 percent of revenues.

Operating Expenses	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Total	552,141	276,162	790,876	691,339
Per boe	7.82	5.17	7.13	5.76

Arcan's operating expenses are currently below industry averages, but have increased since June 30, 2006 due to Arcan moving toward oil-weighted production. Transportation costs are included in operating expenses and amounted to \$57,785 for the six months ended December 31, 2006 (year ended June 30, 2006 - \$186,357). Going forward, Arcan's continued transition towards oil-weighted production, including costs to operate the enhanced recovery, is anticipated to result in higher average operating costs per unit of production.

Netbacks	Three months		Six months	Year
	December	June	December	June
\$ per boe	2006	2006	2006	2006
Revenue	57.27	57.00	56.85	55.83
Royalty, net of ARTC	13.86	13.89	12.96	14.61
Operating expenses	7.82	5.17	7.13	5.76
Netbacks	35.59	37.94	36.76	35.46

Netbacks have increased compared to the year ended June 30, 2006. This is the result of Arcan's production moving to a higher oil weighting which has increased Arcan's price on a per BOE basis. A decrease in royalties was mostly offset by an increase in operating costs per BOE. While Arcan expects price fluctuations over the upcoming year, overall price levels are expected to remain consistent, royalty rates are expected to remain relatively stable, and operating costs are expected to increase. These factors would reduce the netbacks received by Arcan.

General and Administrative ("G&A")	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Total	775,723	729,193	1,351,960	1,096,955
Per boe	10.99	13.67	12.19	9.14

G&A expenses for the period ended December 31, 2006 increased over those for the year ended June 30, 2006 due to the increase in corporate and operating activities. Arcan does not capitalize any G&A. In its role as operator of its oil and natural gas properties, the standard industry operating agreements provide for the charging of certain administrative costs to its joint venture capital expenditure programs and well operations. Arcan expects the G&A costs to grow in total as Arcan continues to increase activity levels, expects the G&A costs to decline on a "per boe" basis due to expected growth in volumes of boe's produced.

Stock-Based Compensation	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Total	156,312	419,202	377,476	1,019,872
Per boe	2.22	7.86	3.40	8.50

Stock-based compensation for the period ended December 31, 2006 has decreased on an overall basis and on a per BOE basis compared to the year ended June 30, 2006. The decrease is due to a portion of the employee stock options issued during the year ended June 30, 2006 vesting completely when they were granted which brings the full stock-based compensation amount into income immediately, while all of the options issued during the period ended December 31, 2006 being issued with vesting terms over two years which brings the stock-based compensation into income over the vesting period. Stock-based compensation is a non-cash expense, which represents the estimated fair value of performance and other stock options granted to employees as a motivational incentive. Arcan expects stock-based compensation to increase as new options are issued, but decrease on a per unit basis as volumes increase.

Interest Expense	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Total	108,409	-	112,548	-

Arcan began drawing on its bank facility and incurred interest expense during the six month period ended December 31, 2006. Subsequent to the period, Arcan has continued to increase its draws on its bank facility and expects to carry bank debt as required as part of routine operations as required on an ongoing basis. Increased debt will increase interest expense.

Depletion, Depreciation and Accretion ("DD&A")

	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Depletion and depreciation	1,688,659	1,776,211	2,706,107	4,115,091
Accretion	62,293	7,900	92,511	18,263
Total	1,750,952	1,784,111	2,798,618	4,133,354
Per boe	24.81	33.44	25.24	34.45

The additional DD&A is due to the increase in sales volumes combined with significant expenditures on Arcan's three core oil and gas properties. High depletion and depreciation per boe reflects the impact of booking reserves under the conservative evaluation rules of the National Instrument 51-101. Arcan expects these costs to decline on a per boe basis as its fields continue to be developed, resulting in more oil and natural gas reserves being officially recognized by its independent evaluation engineering firm.

Income Taxes	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Future income tax (expense) recovery	146,924	82,850	169,293	253,465

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 December 2006	Year June 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 was classified as a Canadian Controlled Private Company, which enabled it to use the Small Business Deduction to reduce its income tax rate. Since Arcan has become a public company (see Subsequent Events), it has lost access to the Small Business Deduction, which has increased its future income tax rate.

The components of the future income taxes are as follows:

\$	December 2006	June 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)

Arcan has not paid any cash taxes and has accumulated sufficient tax deductions such that it does not anticipate paying any taxes for the next few years. However, Arcan is not able to forecast future possible changes in Federal and Provincial tax regimes.

Liquidity and Capital Resources

Arcan is engaged in a substantial capital expenditure program to develop its three core oil and natural gas properties to their full potential. The financing for this program is provided primarily by issuing new equity, and also through cash provided by operating activities and from bank loans. Arcan expended \$33.4 million on its properties during the period compared to \$34.2 million for the year ended June 30, 2006. Arcan generated \$2.4 million in cash provided by operating activities, and at December 31, 2006 had borrowed \$11.5 million from its bank loan facility.

At December 31, 2006, Arcan had a bank operating facility available in the amount of \$20 million. During the period ended December 31, 2006, Arcan had drawn \$11.5 million on its bank facility and expects to carry bank debt as part of routine operations as required on an ongoing basis. Increased debt will increase interest expense.

Arcan Estimates that at March 30, 2007, due to rapid growth in its capital expenditures, coupled with delays in generating cash flow from its recently drilled wells, its debt and working capital deficiency is approximately \$30 million, which is in excess of its current debt facility. To correct this situation, Arcan will be renegotiating its current facility, and potentially raising additional equity or obtaining alternative debt facilities.

Arcan expects its substantial capital expenditure program to continue into the upcoming year. Arcan expects the expenditures to be financed by additional equity issues, the use of its bank facility, and by Arcan's cash provided by operating activities. Arcan also expects the Amalgamation with Desco to provide Arcan with additional access to public equity markets.

The components of Arcan's working capital (deficiency) are as follows:

\$	December 2006	June 2006
Current assets	13,864,690	23,235,682
Less:		
Accounts payable and accrued liabilities	18,107,588	12,907,955
Bank loan	11,502,221	-
Working capital (deficiency)	(15,745,119)	10,327,727

Pursuant to the terms of an Agency Agreement dated July 30, 2004, under which Arcan issued 514,920 flow-through Arcan Shares and 2,640,000 units comprised of one Arcan Share and 0.2 of a warrant to purchase an Arcan Share, subscribers received one right for each flow-through Arcan Share and unit subscribed for. Each right entitles the holder to be issued an additional 0.10 Arcan 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 Arcan issued 315,492 Arcan Shares for no additional consideration in this regard.

Arcan completed a private placement on November 3, 2006 of 838,224 units at \$6.00 per unit for gross proceeds of \$5,029,344. Each unit was comprised of one Arcan Share at \$2.80 per share, together with one flow-through Arcan Share at \$3.20 per share. Arcan has until December 31, 2007 to incur \$2,682,317 of qualifying flow-through expenditures which will be renounced to the flow-through investors.

Capital Expenditures	Three months		Six months	Year
	December	June	December	June
\$	2006	2006	2006	2006
Geological and geophysical	(9,481)	27,220	40,680	520,501
Land	411,201	1,498,438	1,821,465	3,337,811
Acquisitions	863,141	7,064,780	10,404,774	8,768,949
Drilling and completions	5,536,371	(506,983)	12,859,547	15,399,405
Equipment and facilities	3,414,047	(102,264)	8,240,567	4,985,379
Corporate assets	154,116	957,652	409,175	1,137,220
Total	10,369,395	8,938,843	33,776,208	34,149,265

Arcan increased its capital expenditure program considerably for the period ended December 31, 2006. During the period, Arcan purchased additional interests in the Deer Mountain Unit No. 2, drilled eight (6.0 net after earned interest) wells, which resulted in four (2.8 net after earned interest) oil wells, two (1.7 net after earned interest) gas wells, one (0.8 net after earned interest) standing well, and one (0.8 net after earned interest) water injector well. In addition, Arcan purchased land, shot seismic, built facilities, and worked over several wells.

Deer Mountain Unit No. 2 - On September 28, 2005, Arcan purchased a net 10.4% working interest in this 40 degree API sweet light oil, long reserve life property, together with an option to acquire an additional 65.4% working interest. Arcan is the Unit operator of the field. Arcan's long term strategy with the Unit is to implement a field wide water flood Enhanced Recovery Scheme (EOR) through infill drilling of producing oil wells and water injectors in order to increase both the production rates and the oil reserves. Successful implementation of the EOR program is expected to substantially increase the value of this property.

During the period, Arcan exercised its option and purchased the additional 65.4% working interest, increasing its total Deer Mountain Unit working interest to 75.8%, for a net cost of \$9.6 million. Arcan has also completed an 18 square kilometer 3D seismic program on the Unit and is presently evaluating it.

During the period, Arcan drilled four (3.0 net) wells at Deer Mountain, which resulted in three (2.3 net) oil wells, and one (0.8 net) water injector well. Arcan also continued working on a major upgrade to the facilities to handle increased production volumes, with the new battery commencing operations in December 2006. Water handling facilities were completed and on stream by the end of February 2007. In addition, workovers are ongoing on existing producers, adding incremental volumes and reserves.

Chinchaga (Hamburg) - Hamburg is one of Arcan's core operating areas in which Arcan has extensive technical expertise. During the year ended June 30, 2006, Arcan drilled six wells (3.2 net) at Hamburg, resulting in two significant sweet light oil wells, one gas well, two standing wells, and one suspended well. During the period ended December 31, 2006, Arcan drilled two wells (1.3 net) in the area, resulting in one sweet light oil well and one standing well. Arcan drilled three (2.5 net) additional locations here subsequent to the quarter, which resulted in two oil wells and one water source well. The oil discoveries have set up an extensive 2007 development drilling program with plans of implementing an EOR water flood scheme upon successful drilling results. Presently five wells are rate restricted by the regulators, but upon implementation of the EOR water flood, Arcan expects the production rates to significantly increase.

McLeod - Arcan has 60% to 85% working interests in its McLeod assets, an area with multiple zones containing oil and natural gas. During the period ended December 31, 2006, Arcan drilled two wells (1.7 net), resulting two producing gas wells. Arcan drilled one additional location in the area subsequent to the quarter and tied in two previously drilled wells and increased production from approximately 300 to 800 boe per day.

Arcan expects its substantial capital expenditure program to continue into the upcoming year. Based on development and exploration opportunities in Chinchaga, the development and exploitation opportunities in the Deer Mountain Unit and the exploration and development plans for McLeod, Arcan believes it has a large balanced inventory of exploration development and exploitation opportunities which will provide a platform for continued growth.

Related Party Transactions

The following transactions with related parties were recorded at the exchange amount which was done on a fair value basis defined as the amounts that would be agreed upon in an arm's length transaction between knowledgeable, willing parties, who are under no compulsion to act.

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 Arcan by Blake, Cassels & Graydon LLP, a legal firm at which a director and Corporate Secretary of Arcan, Mike Laffin, is a partner. The business purpose is for the normal course supply of legal services to Arcan. 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 Arcan, Hank Swartout, is a director and officer. As of December 31, 2006, \$854,749 (June 30, 2006 - \$1,228,279) was in accounts payable.

On September 28, 2005, Arcan 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 and a unit (the “Unit”) for net cash consideration of \$1.8 million. In October 2005, Arcan sold a 0.5% Unit interest for cash consideration of \$88,000 to 509212 Alberta Ltd., a company owned by Ed Gilmet, the President and CEO of Arcan (the “Purchaser”). Arcan 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. The business purpose is to obtain a joint venture partner to assist with both the financing of the cost of the acquisition and with the implementation of Arcan’s development strategy.

Amounts charged by Arcan to 509212 Alberta Ltd., 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.

Arcan is the operator of two properties in which Desco Energy Ltd., a corporation related through common shareholders, is a joint venture partner. Amounts charged by Arcan, 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. The business purpose is to obtain a joint venture partner to reduce the exploration risk to Arcan.

A share purchase loan of \$100,000 (June 30, 2006 - \$100,000) is due from Doug Penner, the CFO and V.P. Finance of Arcan, for the purchase of 40,000 (2005 – nil) Arcan Shares at a price of \$2.50 per 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 Arcan Shares. This loan was negotiated as a part of the initial employment agreement with Mr. Penner.

Contractual Obligations

Arcan has the following 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

(b) As a requirement of a sublease for office premises, Arcan 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

Off-Balance Sheet Obligations

At June 30, 2006, Arcan had obligations under the Deer Mountain Unit Participation and Option to Purchase Agreement, as described below. During the period ended September 30, 2006, Arcan discharged the obligations by exercising the Option. This achieved Arcan's business objective, which was to purchase an initial interest in the Deer Mountain Unit, while retaining the right to purchase an increased interest in the Deer Mountain Unit at a later date.

Pursuant to a September 2005 Participation and Option to Purchase Agreement (the "Option") with a third party (the "Corporation"), Arcan had an Option to purchase the Corporation's 65.4% interest in the Deer Mountain Unit for a period of 22 months from the date of the Option agreement. The Option price is based on when the option is exercised, for a minimum price of \$13.1 million and a maximum price of \$16.5 million, plus capital expenditures related to the Deer Mountain Unit incurred by the Corporation and reduced by 85% of the Corporation's net cash flow from the Deer Mountain Unit.

In addition, should Arcan have failed to exercise the Option within the first 18 months of the Option period (a "triggering event"), the Corporation may convey its 65.4% Unit interest to Arcan (the "Put Option") in exchange for Arcan Shares equal to the Option price. The Arcan Shares would be valued at \$1.85 per Arcan Share if Arcan is not publicly traded, and the lesser of \$1.85 per share or 95% of the 10-day weighted average trading price of the Arcan Shares if Arcan is publicly traded. The Put Option expires 30 days after such a triggering event occurs. Arcan exercised the Option in August 2006.

Outstanding Share Data

	December 31,	June 30,	March 30,
Arcan's issued share capital consists of:	2006	2006	2007
Common shares	26,534,045	24,542,105	29,012,936
Warrants	1,287,810	1,287,810	1,182,250
Performance options	1,500,000	1,500,000	1,500,000
Stock options	2,483,500	2,263,500	2,682,500
Performance shares	-	-	6,550,400

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 pursuant to TSXV Policy 5.2. Upon completion of the Amalgamation the name of the amalgamated corporation ("Amalco") was designated as "Arcan Resources Ltd."

Pursuant to the Amalgamation Agreement, each outstanding common share in the capital of Desco Energy Ltd. ("Desco Share") was converted into 0.36231884 of an Amalco Share, together with one Amalco Performance Share. Certain founding Desco Shareholders agreed to cancel 2,349,600 of their Desco Shares for nil proceeds in connection with the Amalgamation.

Each Amalco Performance Share will, on or before November 1, 2008, either be 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 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.

Desco had 6,550,400 common shares outstanding at the effective time of the Amalgamation, each of which was converted into 0.36231884 of an Amalco Share resulting in a total of 2,373,333 Amalco Shares being issued in exchange for the Desco Shares.

In addition, pursuant to the Amalgamation Agreement, each Arcan Share was converted into one Amalco Share and each outstanding stock option, warrant and performance warrant of Arcan will be 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 the two companies were amalgamated 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.

The Amalgamation of Arcan and Desco is expected to result in larger base of oil and natural gas properties and increased oil and natural gas reserves, daily oil and natural gas production rates and cash provided by operating activities.

Outlook

Arcan is planning for additional drilling and re-completions, together with new oil and water handling facilities at Deer Mountain, and two to four gas wells in McLeod. Arcan is planning on four to five wells in Hamburg. Success in Hamburg could lead to a total of up to ten wells, including producing wells, water source wells and injection wells over the next few years. To fund this activity Arcan is expecting to use several sources of financing, including new equity, when available on favourable terms, as well as internally generated cash flow, and bank debt.

Arcan expects that the planned Amalgamation with Desco will provide Arcan with additional access to public equity markets, and will provide Arcan Shareholders with the liquidity of a public market. Desco's properties consist of working interests in the Hamburg and McLeod properties that are already operated by Arcan, so this fits with Arcan's strategy of maintaining high working interests in its properties.

Based on development and exploration opportunities in Chinchaga (Hamburg), the development and exploitation opportunities in the Deer Mountain Unit and the exploration plans for McLeod, Arcan believes that it has a large balanced inventory of exploration, development and exploitation opportunities which will provide a platform for continued growth.

Disclosure Controls and Procedures

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the Company is accumulated and communicated to our management as appropriate to allow timely decisions regarding required disclosure. The Company's Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of December 31, 2006, that the Company's disclosure controls and procedures are effective to provide reasonable assurance that material information related to the Company, is made known to them by others with the entity. It should be noted that while the Company's Chief Executive Officer and Chief Financial Officer believe that our disclosure controls and procedures provide a reasonable level of assurance and that they are effective, they do not expect that the disclosure controls and procedures will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

Internal Controls Over Financial Reporting

The Chief Executive Officer and Chief Financial Officer of the Company are responsible for designing internal controls over financial reporting or causing them to be designed under their supervision in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. We have assessed the design of our internal control over financial reporting and during this process we have identified certain weaknesses in internal controls over financial reporting which are follows:

- Due to the limited number of staff at the Company, it is not possible to achieve complete segregation of duties;
- Due to the size of the Company and the limited number of staff, the Company does not have the technical accounting expertise and knowledge to address all complex and non-routine accounting transactions that may arise; and
- Many of the Company's information systems are subject to general control deficiencies including lack of controls over spreadsheets, access and documentation.

These weaknesses in the Company's internal controls over financial reporting result in a more than remote likelihood that a material misstatement would not be prevented or detected. Management and the board of directors worked to mitigate the risk of material misstatement in financial reporting. In addition, when complex accounting and technical issues arise during preparation of the quarterly financial statements outside consulting expertise is engaged. In spite of management's best efforts, there can be no assurance that this risk can be reduced to less than a remote likelihood of a material misstatement.

Business Risks

Arcan is engaged in the business of exploration, development, production and acquisition of crude oil and natural gas. This business has many risks that even a combination of knowledge, experience and careful evaluation may not be able to overcome. These risks may cause the Arcan's actual performance and financial results in future periods to differ materially from any estimates or projections of future performance or results expressed or implied by its forward-looking statements.

Arcan's principal business risks are related to finding and developing economic hydrocarbon reserves efficiently and being able to fund the capital expenditure program. Without the ongoing addition of new oil and natural gas reserves, any existing reserves Arcan has, and the production there from, will decline over time as the existing reserves are produced. A future increase in Arcan's reserves will depend not only on its ability to explore and develop any properties it has, but also on its ability to acquire suitable producing properties or prospects. No assurance can be given that further commercial quantities of oil and natural gas will be discovered or acquired by Arcan.

Arcan's need for capital will be both short-term and long-term in nature. Short-term working capital will be required to finance accounts receivable, drilling deposits and other similar short-term assets, while the acquisition, exploration and development of oil and natural gas properties requires substantial amounts of long-term capital. Arcan uses several sources of financing, including new equity, when available on favourable terms, as well as internally generated cash flow, and bank debt.

Financial risks associated with the petroleum industry include fluctuations in commodity prices, interest rates, and currency exchange rates. Operational risks include competition, environmental factors, reservoir performance uncertainties, a complex regulatory environment and safety concerns.

The supply of service and production equipment at competitive prices is critical to the ability to add reserves at a competitive cost and produce them in an economic and timely fashion. In periods of increased activity, these services and supplies can become difficult to obtain. Arcan attempts to mitigate this risk by developing strong long-term relationships with suppliers and contractors, and by maintaining an appropriate inventory of production equipment.

Arcan's Chinchaga (Hamburg) oil and natural gas property is in a winter access only area. This results in a limited time frame available to conduct Arcan's annual capital expenditure program in this area. This creates risks for cost overruns when operations have to be rushed. Time overruns can also happen whereby spring breakup occurs before a newly drilled well is completed and tied in, resulting in a one year delay in being able to put the well on production and have it generate revenue for Arcan.

Arcan attempts to manage its business risks. Firstly, Arcan has an experienced, talented, and highly motivated staff of oil and natural gas professionals. Arcan also operates almost all of its properties. This enables Arcan to control the timing, direction and costs related to exploration and development opportunities. Arcan's geological focus is on areas in which the prospects are well understood by management. Technological tools are regularly used to reduce risk and increase the probability of success. Arcan closely follows all government regulations and has an up-to-date emergency response plan that has been communicated to field operations by management. Arcan also carries insurance coverage to attempt to minimize potential losses.

Critical Accounting Estimates

Management is often required to make judgments, assumptions and estimates in the application of generally accepted accounting principles that have a significant impact on the financial results of Arcan. A comprehensive discussion of Arcan's significant accounting policies is contained in note 2 to the annual Financial Statements. The following is a discussion of the accounting estimates that are critical in determining Arcan's financial results.

(a) Full cost accounting

Arcan follows the full cost method of accounting for exploration and development activities whereby all costs associated with these activities are capitalized, whether successful or not. The aggregate of capitalized costs, net of certain costs related to unproven properties, and estimated future development costs is amortized using the unit-of-production method based on estimated proved reserves. Changes in estimated proved reserves or future development costs have a direct impact on depletion and depreciation expense.

Certain costs related to unproved properties and major development projects may be excluded from costs subject to depletion until proved reserves have been determined or their value is impaired. These properties are reviewed quarterly to determine if proved reserves should be assigned, at which point the costs are included in the total cost base for purposes of calculating depletion and for evaluating impairment.

The alternative method of accounting for oil and natural gas properties and equipment is the successful efforts method. The major difference in applying the successful efforts method is that exploratory dry holes and geological and geophysical exploration costs are charged against net earnings in the year incurred rather than being capitalized to property, plant and equipment.

(b) Oil and natural gas reserves

Arcan's proved oil and natural gas reserves are 100 percent evaluated and reported by an independent petroleum engineering consultant. The estimation of reserves is a subjective process. Forecasts are based on engineering data, projected future rates of production, estimated commodity price forecasts and the timing of future expenditures, all of which are subject to a number of uncertainties and various interpretations.

Arcan expects that over time its reserve estimates will be revised upward or downward based on updated information such as the results of future drilling, testing and production levels. Reserve estimates can have a significant impact on net earnings, as they are a key component in the calculation of depletion and depreciation. A revision to the reserve estimate could result in a higher or lower DD&A charge to net earnings. Downward revisions to reserve estimates could also result in a write-down of oil and natural gas property, plant and equipment under the ceiling test.

(c) Full cost accounting ceiling test

The carrying value of property, plant and equipment is reviewed annually for impairment. Impairment is determined when the carrying value of Arcan's property, plant and equipment exceeds the sum of the undiscounted cash flows expected to result from Arcan's proved reserves. Cash flows are calculated based on third-party quoted forward prices and are adjusted for Arcan's contract prices and quality differentials.

If impairment is deemed to occur, the magnitude is calculated by comparing the carrying value of property, plant and equipment to the estimated net present value of future cash flows from proved plus probable reserves. A risk-free interest rate is used to arrive at the net present value of the future cash flows. Any excess carrying value above the net present value of future cash flows would be recorded as a permanent impairment and charged as additional depletion expense in the Statement of Operations. No write-down was required at December 31, 2006.

(d) Asset retirement obligations

Arcan recognizes the fair value of its asset retirement obligations ("ARO") in the period in which it is incurred and when a reasonable estimate of its obligations can be made. The fair value of the estimated ARO is recorded as a long-term liability, with a corresponding increase in the carrying amount of the related asset. The capitalized amount is depleted on a unit-of-production basis over the life of the reserves. The liability amount is increased each reporting period with the passage of time and the amount of this accretion is charged to earnings in the period. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost would also result in an increase or decrease to the ARO.

Actual costs incurred upon settlement of the ARO are charged against the ARO to the extent of the liability recorded. Any difference between the actual cost incurred upon settlement of the ARO and the recorded liability is recognized as a gain or loss in Arcan's earnings in the period in which the settlement occurs. Determinations of the original undiscounted costs are based on engineering estimates using current costs and technology in accordance with existing legislation and industry practice. The estimation of these costs can be affected by factors such as the number of wells drilled, well depth and area-specific environmental legislation.

(e) Future income tax

Arcan follows the liability method of accounting for income taxes. Under this method income tax liabilities and assets are recognized for the estimated tax consequences attributable to differences between the amounts reported in the financial statements and their respective tax base, using substantively enacted future income tax rates. In June 2003, the Federal Government introduced a gradual reduction in the general corporate income tax rate over a five year period starting January 1, 2003.

The impact of the Federal legislation requires Arcan to schedule all existing temporary differences, identify the accounting and tax values during the phase-in period for the declining tax rates and recalculate the future income tax balance using tax rates in effect when temporary differences reverse. The above-noted forecasts of estimated net revenue streams are utilized to calculate the future tax provision and, as such, are subject to revisions, both upwards and downwards, that are not known at this time. In addition to these revisions, future capital activities can impact the timing of the reversal of any temporary differences. These differences can have an impact on the amount of future taxes determined at a point in time. To the extent that these differences are created, they can impact the charge against earnings for future income taxes.

(f) Stock-based compensation

Arcan's Stock Option Plan provides for the granting of options to directors, officers and employees. Arcan uses the fair value method for valuing stock option grants. Compensation costs attributable to share options granted are measured at fair value at the grant date and are expensed over the expected vesting time-frame with a corresponding increase to contributed surplus. Upon exercise of stock options, consideration paid by the option holder, together with the amount previously recognized in contributed surplus, is recorded as an increase in share capital.

New Accounting Policies

The CICA released new standards related to financial instruments in April 2005 - Financial Instruments - Recognition and Measurement, Section 3855, Hedges, Section 3865, Comprehensive Income, Section 1530, Financial Instruments - Disclosure and Presentation, Section 3861 and Equity, Section 3251. These sections specify when a financial instrument or non-financial derivative is to be recognized on the balance sheet. These sections will require a financial instrument or non-financial derivative to be measured at fair value of using cost-based measures; establish how gains and losses are to be recognized and presented, including introducing comprehensive income; specify how hedge accounting should be applied; establish new disclosures about an entity's accounting for designated hedging relationships and methods and assumptions applied in determining fair values.

The Company will adopt these new standards commencing January 1, 2007 and as at the date of the management's discussion and analysis cannot reasonably estimate the full effect on its financial statements.

Legal Advisories

Oil, Natural Gas Liquids ("NGL's"), and Natural Gas Conversions to BOE's

Barrels of oil equivalent ("boe's") may be misleading, particularly if used in isolation. A boe conversion ratio of six thousand cubic feet of natural gas to one barrel of oil is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

Non-GAAP Measurements

Readers are cautioned that this MD&A contains the term "funds flow from operations" which should not be considered an alternative to, or more meaningful than, cash provided by operating activities or net earnings as determined in accordance with GAAP as an indicator of Arcan's performance. Funds flow from operations plus change in non-cash working capital equals cash provided by operating activities, the reconciliation of which can be found in this MD&A and also in the statements of cash flows. Arcan also presents funds flow from operations per share, whereby funds flow from operations is divided by the basic weighted average number of shares outstanding to determine per share amounts. "Netbacks" are also presented which represents Arcan's revenue per boe, less per boe royalties, operating expenses and transportation expenses, in order to determine the amount of funds generated by each boe produced.

These measures do not have any standardized meaning prescribed by GAAP and therefore are unlikely to be comparable to similar measures presented by other companies. Management believes that funds flow from operations and netbacks are useful supplemental measures as they provide an indication of the ability of Arcan to fund future growth through capital investment and/or repay debt. These measures have been described and presented in this MD&A in order to provide shareholders and potential investors with additional information regarding Arcan's liquidity and its ability to generate funds to finance its operations.

Forward Looking Statements

In the interest of providing Arcan shareholders and potential investors with information regarding the Company, including management's assessment of Arcan's future plans and operations, certain statements contained in this MD&A constitute forward-looking statements or information (collectively referred to herein as "forward-looking statements") within the meaning of the "safe harbour" provisions of applicable securities legislation. Forward looking statements are typically identified by words such as "anticipate", "believe", "expect", "plan", "intend", "forecast", "target", "project" or similar words suggesting future outcomes or statements regarding an outlook.

Forward-looking statements in this MD&A include, but are not limited to, statements with respect to: projections with respect to growth of production and reserves; projections relating to the volatility of oil and natural gas prices and the reasons therefore; Arcan's projected capital investment levels and the source of funding therefore; the effect of Arcan's risk management program, including the impact of derivative financial instruments; the adequacy of Arcan's provision for taxes; and the impact of changes in accounting principles on future financial statements.

Readers are cautioned not to place undue reliance on forward-looking statements, as there can be no assurance that the plans, intentions or expectations upon which they are based will occur. By their nature, forward-looking statements involve numerous assumptions, known and unknown risks and uncertainties, both general and specific, that contribute to the possibility that the predictions, forecasts, projections and other forward-looking statements will not occur, which may cause Arcan's actual performance and financial results in future periods to differ materially from any estimates or projections of future performance or results expressed or implied by such forward-looking statements.

These risks and uncertainties include, among other things: volatility of and assumptions regarding oil and gas prices; fluctuations in currency and interest rates; product supply and demand; market competition; risks inherent in Arcan's marketing operations, including credit risks; imprecision of reserve estimates and estimates of recoverable quantities of oil, natural gas and liquids; Arcan's ability to replace and expand oil and gas reserves; risks associated with technology; its ability to generate sufficient cash from operations to meet its current and future obligations; Arcan's ability to access external sources of debt and equity capital; the timing and the costs of well and pipeline construction; Arcan's ability to secure adequate product transportation; changes in environmental and other regulations or the interpretations of such regulations; political and economic conditions; terrorist threats; risks associated with potential future lawsuits and regulatory actions made against Arcan; and other risks and uncertainties described from time to time in the reports and filings made with securities regulatory authorities by Arcan.

Statements relating to "reserves" are deemed to be forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions that the resources and reserves described exist in the quantities predicted or estimated, and can be profitably produced in the future. Although Arcan believes that the expectations represented by such forward-looking statements are reasonable, there can be no assurance that such expectations will prove to be correct. Readers are cautioned that the foregoing list of important factors is not exhaustive. Furthermore, the forward-looking statements contained in this MD&A are made as of the date of this MD&A, and Arcan does not undertake any obligation to update publicly or to revise any of the included forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. The forward-looking statements contained in this MD&A are expressly qualified by this cautionary statement.

Summary Of Quarterly Operating And Financial Results For The Eight Most Recent Quarters

Fiscal quarter ended	2006				2005			
	December	September	June	March	December	September	June	March
Operating								
Oil and NGL's (bbls per day)	531	221	268	131	110	1	1	1
Price (\$/bbl)	63.02	73.07	76.64	61.26	55.82	38.76	58.29	60.89
Natural gas (mcf per day)	1,466	1,303	1,908	2,406	501	59	52	70
Price (\$/mcf)	7.46	6.47	6.74	8.11	12.11	10.48	7.54	7.74
Barrels of oil equivalent (boe per day)	775	438	586	532	193	11	9	13
Financial (\$000's, except per share amounts)								
REVENUES								
Petroleum and natural gas	4,042	2,262	3,041	2,476	1,122	60	40	55
Royalties	(978)	(460)	(741)	(681)	(325)	(6)	(7)	(12)
Interest income	1	76	69	11	48	50	(1)	7
Net revenues	3,065	1,879	2,369	1,806	845	104	32	50
EXPENSES								
Operating	552	239	276	318	92	6	9	10
General and administrative	776	576	729	164	113	91	167	80
Stock-based compensation	156	221	419	157	78	365	116	89
Interest	108	4	-	-	-	-	-	-
Accretion	62	30	8	6	4	1	-	-
Depletion and depreciation	1,689	1,017	1,776	1,850	471	17	16	17
	3,343	2,088	3,208	2,495	758	480	308	196
Net earnings (loss) before income taxes	(278)	(209)	(839)	(689)	87	(376)	(276)	(146)
Future income tax recovery (expense)	147	22	83	171	-	-	9	36
Net earnings (loss) for the period	(131)	(187)	(756)	(518)	87	(376)	(267)	(110)
Earnings (loss) per share - basic	(0.01)	(0.01)	(0.04)	(0.04)	0.01	(0.03)	0.06	(0.03)
Funds flow from operations	1,629	1,060	1,364	1,325	640	8	(145)	(40)
Per share - basic	0.06	0.04	0.07	0.10	0.05	0.00	(0.03)	(0.01)
Netbacks (\$/boe)								
Petroleum and natural gas revenues	57.27	56.10	57.00	51.74	63.09	60.50	46.40	47.76
Royalties	13.86	11.40	13.89	14.23	18.27	6.36	8.65	10.54
Operating and transportation expenses	7.82	5.92	5.17	6.63	5.19	5.73	10.38	8.85
Netbacks	35.59	38.78	37.94	30.88	39.63	48.41	27.37	28.37
Total assets (\$000's)	82,019	69,372	57,854	35,804	25,842	19,988	4,964	4,932

Arcan is investing substantial funds in its three core areas, as can be seen from the ongoing growth in total assets. Arcan's sales have also been increasing, although the current quarter has declined due to some temporary production and regulatory issues. Arcan expects that sales volumes will continue to grow in subsequent quarters. Oil and gas prices continue to fluctuate and have declined this quarter from recent unusually high levels.

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

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

Arcan Resources Ltd.

Balance Sheets

As at December 31, 2006 and June 30, 2006

	December 31, 2006	June 30, 2006
ASSETS		
Current assets		
Cash	\$ -	\$ 14,936,785
Accounts receivable	13,864,690	8,298,897
	13,864,690	23,235,682
Property, plant and equipment (note 4)	68,153,872	34,618,693
	\$ 82,018,562	\$ 57,854,375
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	\$ 18,107,588	\$ 12,907,955
Bank loan (note 5)	11,502,221	-
	29,609,809	12,907,955
Asset retirement obligations (note 6)	3,268,469	710,880
Future income taxes (note 7)	1,009,916	1,183,572
	33,888,194	14,802,407
SHAREHOLDERS' EQUITY		
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)
	48,130,368	43,051,968
	\$ 82,018,562	\$ 57,854,375

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
REVENUES		
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)
	4,943,940	5,124,664
EXPENSES		
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
	5,431,478	6,941,520
Loss before income taxes	(487,538)	(1,816,856)
Future income tax reduction (note 7)	169,293	253,465
NET LOSS FOR THE PERIOD	(318,245)	(1,563,391)
Deficit, beginning of period	(2,256,459)	(693,068)
Deficit, end of period	\$ (2,574,704)	\$ (2,256,459)
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):		
OPERATING		
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)
	2,688,556	3,336,370
Change in non-cash working capital	(341,046)	(454,680)
	2,347,510	2,881,690
FINANCING		
Bank loan	11,502,221	-
Issue of common shares, net of costs	5,014,806	41,187,229
	16,517,027	41,187,229
INVESTING		
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
	(33,801,322)	(29,261,552)
Increase (decrease) in period	(14,936,785)	14,807,367
Cash, beginning of period	14,936,785	129,418
Cash, end of period	\$ -	\$14,936,785
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
	\$ -	\$14,936,785

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	11,502,221	-

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 ⁽ⁱ⁾	5,187,600	8,300,160
Flow-through shares issued ⁽ⁱ⁾	3,228,400	5,972,540
Tax effect of flow-through shares	-	(2,143,523)
Warrants exercised	5,560	8,896
Common shares issued ⁽ⁱⁱ⁾	6,800,000	17,000,000
Common shares issued ⁽ⁱⁱⁱ⁾	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 ^(iv)	315,492	-
Common shares issued ^(v)	838,224	2,347,027
Flow-through shares issued ^(v)	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 ⁽ⁱ⁾	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)) ⁽ⁱⁱ⁾	1.60	122,311
Balance, at June 30, 2005	1.68	886,930
Warrants issued ⁽ⁱⁱⁱ⁾	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:

	Six months ended December 31, 2006	Year ended June 30, 2006
Weighted average common shares outstanding - basic	25,294,604	14,507,604
Weighted average common shares outstanding - diluted	25,294,604	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,	2006	2005
Fair value of options granted (\$/option)	0.98	0.45
Expected life of options (years)	10	10
Expected volatility (%)	—	—
Risk free rate of return (%)	4.2	3.3
Expected dividend yield (%)	Nil	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

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