



**2008 Consolidated Financial Statements**

## **MANAGEMENT'S RESPONSIBILITY STATEMENT**

The consolidated financial statements of Arrow Energy Ltd. and all information in this report are the responsibility of management and have been approved by the Board of Directors. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The consolidated financial statements include amounts that are based on estimates, which have been objectively developed by management using all relevant information. All financial and operating data in this report is consistent with the information in the consolidated financial statements.

Arrow Energy Ltd. maintains appropriate systems of internal control to give reasonable assurance that transactions are appropriately authorized, assets are safeguarded from loss or misuse and financial records are properly maintained to provide reliable information for the preparation of financial statements. Arrow Energy Ltd. has effective disclosure controls and procedures to ensure timely and accurate disclosure of material information relating to the Company which complies with the current requirements of Canadian securities legislation.

Deloitte and Touche LLP, an independent firm of chartered accountants, has been engaged to examine the financial statements and provide their auditors' report. Their report is presented with the consolidated financial statements.

The Board of Directors are responsible for ensuring that management fulfils its responsibilities for financial reporting and internal control. The Board of Directors carries out this responsibility principally through its Audit Committee. The Audit Committee is comprised entirely of independent directors and meets regularly with management and with the Company's external auditors to discuss the results of their audit examination and to review issues related thereto. The external auditors have full access to the Audit Committee with and without the presence of management. The Audit Committee reviews the consolidated financial statements and Management's Discussion and Analysis and recommends their approval to the Board of Directors.

Signed "*Robyn Lore*"

Robyn Lore  
President  
Calgary, Alberta / April 16, 2009

## **AUDITORS' REPORT TO THE SHAREHOLDERS**

We have audited the consolidated balance sheets of Arrow Energy Ltd. as at December 31, 2008 and 2007 and the consolidated statements of operations, comprehensive loss and deficit and cash flows for the years then ended. 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 audits.

We conducted our audits 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 consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Signed "*Deloitte & Touche LLP*"

Chartered Accountants  
Calgary, Alberta / April 16, 2009

# Consolidated Balance Sheets

Years ended December 31

	2008	2007
<b>ASSETS</b>		
Current:		
Cash	\$ 96,921	\$ 155,692
Accounts receivable	775,839	1,765,956
Deposits and prepaid expenses	145,458	236,566
	<u>1,018,218</u>	<u>2,158,214</u>
Property and equipment (Note 5)	17,088,537	20,081,782
Future income tax asset (Note 9)	192,000	-
	<u>\$ 18,298,755</u>	<u>\$ 22,239,996</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES:</b>		
Current:		
Accounts payable and accrued liabilities	\$ 1,798,193	\$ 2,783,684
Bank loan (Note 8, Note 15)	6,064,437	3,037,838
Convertible debenture (Note 14)	162,827	-
	<u>8,025,457</u>	<u>5,821,522</u>
Future income tax liability (Note 9)	-	324,490
Asset retirement obligation (Note 6)	1,340,872	1,081,877
Non-controlling interest (Note 4)	152,768	-
	<u>9,519,097</u>	<u>7,227,889</u>
<b>SHAREHOLDERS' EQUITY:</b>		
Share capital (Note 7)	15,226,946	14,738,683
Equity component of convertible debenture (Note 14)	49,173	-
Contributed surplus (Note 7)	6,713,170	6,306,827
Deficit	(13,209,631)	(6,033,403)
	<u>8,779,658</u>	<u>15,012,107</u>
	<u>\$ 18,298,755</u>	<u>\$ 22,239,996</u>

Going concern (Note 1)

Commitments and contingencies (Note 11)

Subsequent event (Note 15)

## APPROVED ON BEHALF OF THE BOARD:

*Signed Richard Edgar, Director*

*Signed Jason Pack, Director*

See accompanying notes to the financial statements

Arrow Energy Ltd.

# Consolidated Statements of Operations, Comprehensive Loss & Deficit

Years ended December 31

	2008	2007
<b>Revenue</b>		
Petroleum and natural gas sales	\$ 6,127,487	\$ 4,532,810
Royalties	(1,304,195)	(1,200,980)
	<u>4,823,292</u>	<u>3,331,830</u>
Pipeline	994,850	1,318,305
Other income	116,362	43,353
	<u>5,934,504</u>	<u>4,693,488</u>
<b>Expenses</b>		
Production and transportation	1,784,570	1,168,183
Pipeline	934,405	860,511
General and administrative	2,771,467	2,595,221
Interest	341,569	233,106
Stock based compensation (Note 7)	404,084	288,833
Depletion, depreciation, accretion, and impairments (Note 5)	7,514,149	2,902,330
	<u>13,750,244</u>	<u>8,048,184</u>
<b>Loss before income taxes</b>	<b>(7,815,740)</b>	<b>(3,354,696)</b>
<b>Income taxes (Note 9)</b>		
Future	(663,991)	(919,970)
	<u>(663,991)</u>	<u>(919,970)</u>
<b>Net loss attributable before non-controlling interests</b>	<b>(7,151,749)</b>	<b>(2,434,726)</b>
Net loss attributable to non-controlling interest	24,479	-
<b>Net loss and comprehensive loss</b>	<b>(7,176,228)</b>	<b>(2,434,726)</b>
<b>Deficit, beginning of year</b>	<b>(6,033,403)</b>	<b>(3,598,677)</b>
<b>Deficit, end of year</b>	<b>\$ (13,209,631)</b>	<b>\$ (6,033,403)</b>
<b>Net loss per share</b>		
Basic and diluted	\$ (0.26)	\$ (0.14)
<b>Weighted average common shares outstanding</b>		
Basic and diluted	27,686,596	17,079,862

See accompanying notes to the financial statements.

# Consolidated Statements Cash Flows

Years ended December 31

	2008	2007
<b>CASH FLOWS RELATED TO THE FOLLOWING ACTIVITIES</b>		
<b>OPERATING:</b>		
Net loss	\$ (7,176,228)	\$ (2,434,726)
Items not affecting cash:		
Depletion, depreciation, accretion, and impairments	7,514,149	2,902,330
Stock compensation (Note 7 (c))	404,084	288,833
Future income tax recovery	(663,991)	(919,970)
Net loss attributable to non-controlling interest	24,479	–
	<b>102,493</b>	<b>(163,533)</b>
Abandonment expenditures	(43,042)	–
Changes in non-cash working capital (Note 12)	314,770	(119,442)
	<b>374,221</b>	<b>(282,975)</b>
<b>FINANCING:</b>		
Increase in bank loan	3,026,599	1,369,863
Proceeds on issuance of share capital	650,000	2,380,021
Share issue costs	(11,978)	(196,729)
	<b>3,664,621</b>	<b>3,553,155</b>
<b>INVESTING:</b>		
Acquisition of property and equipment	(4,512,262)	(3,580,795)
Acquisition of subsidiaries, net of cash acquired (Note 4)	(485,907)	–
Proceeds on asset disposition	924,296	120,000
Changes in non-cash working capital (Note 12)	(23,740)	346,307
	<b>(4,097,613)</b>	<b>(3,114,488)</b>
<b>Net increase (decrease) in cash</b>	<b>(58,771)</b>	<b>155,692</b>
<b>Cash, beginning of year</b>	<b>155,692</b>	<b>–</b>
<b>Cash, end of year</b>	<b>\$ 96,921</b>	<b>\$ 155,692</b>

See accompanying notes to the financial statements

# Notes to Financial Statements

## For the years ended December 31, 2008 and 2007

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### 1. Description of Business and Basis of Presentation

The principal business of Arrow Energy Ltd. (the “Company” or “Arrow”) is the exploration for, exploitation, development and production of oil and natural gas reserves. All activity is conducted in Western Canada and comprises a single business segment.

#### **Going Concern**

The consolidated financial statements of the Company have been prepared on the going concern basis, which presumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. The Company is relying upon its ability to successfully deliver on business plans and ability to achieve profitable production from existing oil reservoirs. Given the lead time associated with the activities, the Company’s ability to continue as a going concern is dependent on events outside of the Company’s direct control.

The global credit market crisis, the volatility in the price of oil, the recession in Canada and the slowdown of economic growth in the rest of the world has created a substantially more difficult business environment, resulting in an extremely limited ability to execute capital market transactions. Furthermore, the volatile commodity prices are expected to negatively affect the Company’s operating performance. If improvements in market conditions and commodity prices are not realized, the Company may be unable to pay its obligations in the normal course of operations in 2009 or service its debt obligations (Note 8) in a timely fashion. The Company’s suppliers might respond to an apparent weakening of the Company’s liquidity position and to address their own liquidity needs by requesting faster payment of invoices or other assurances. If this were to happen, the Company’s need for cash would be intensified and the Company might be unable to make payments to the Company’s suppliers as they become due.

In order to continue as a going concern, the Company has decreased its 2009 capital expenditures program, reduced general and administrative expenses, and restructured management. The Company is also, among other things, in the process of assessing and redeveloping operations to reduce expenditures, continually working with its financial advisors to optimize all available financing options, examining options to sell underutilized assets, and focusing on optimizing oil and gas production.

The Company’s recent operating losses, negative cash flows, negative working capital, and uncertainty regarding its ability to obtain financing in a timely manner, raises substantial doubt as to the Company’s ability to continue as a going concern. If the going concern basis is not appropriate, adjustments may be necessary to the carrying amounts and classification of the Company’s assets and liabilities. The accompanying consolidated financial statements do not include any adjustments that might result if the Company is unable to continue as a going concern.

## 2. Significant Accounting Policies

### **Basis of Accounting**

The consolidated financial statements include the accounts of Arrow Energy Ltd., its wholly owned subsidiaries and its minority interest (Note 5). All intercompany transactions and balances have been eliminated.

### **Exploration and Development Costs**

The Company follows the full cost method of accounting for petroleum and natural gas properties whereby all costs relating to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized in one Canadian cost centre and charged against income, as set out below. Such costs may include lease and land acquisition costs, geological and geophysical expenses, lease rentals and other costs on non-producing properties, costs of drilling and completing both productive and non-productive wells, production equipment and corporate expenses directly related to acquisition, exploration and development activities. These costs along with estimated future capital costs in the current reserve report related to the development of proved reserves (net of salvage values) are included in the depletion calculation.

Costs of acquiring and evaluating unproved properties may be excluded from the depletion base until it is determined whether proved reserves are attributable to the properties or impairment has occurred.

Depletion of petroleum and natural gas properties and depreciation of production equipment is provided on the unit-of-production basis using estimated gross (before royalties) proved oil and natural gas reserves as determined by independent reservoir engineers. Natural gas reserves and production are converted, at a ratio of six thousand cubic feet of natural gas to one barrel of oil, for depletion and depreciation purposes.

Proceeds from the sale of properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would alter the rate of depletion and depreciation by 20% or more.

The Company calculates a ceiling test by comparing the carrying value of its property, plant and equipment to the sum of undiscounted cash flows expected to result from the future production of the Company's proved reserve base. If the sum of the undiscounted cash flows does not exceed the carrying value, the Company would then measure the amount of the impairment by comparing the carrying values of the petroleum and natural gas properties and equipment to the net present value of future cash flows from proved and probable reserves. A risk-free interest rate is used to arrive at the net present value of future cash flows. Any excess of the carrying value over the Company's future cash flows would be recorded as a permanent impairment.

Unproved properties and undeveloped land are assessed for impairment whenever there are indicators of potential impairment and those deemed impaired are written off.

### **Impairment of long lived assets**

On a periodic basis management assesses the carrying value of long-lived assets for indications of impairment. Indications of impairment include an ongoing lack of profitability and significant changes in technology, processes or the expected economic environment. When an indication of impairment is present, the Company will test for impairment by comparing the carrying value of the asset to its net recoverable amount. If the carrying amount is greater than the net recoverable amount, the asset is written down to its estimated fair value. The Company uses undiscounted future cash flows to determine the net recoverable amount and measures the amount of impairment using discounted cash flows, expected salvage values and other relevant data available in the market.

*(Significant Accounting Policies – continued)*

**Depreciation**

Non-oil and gas assets are depreciated over their respective estimated useful lives using the declining-balance method at annual rates of 20% and 30%. Leasehold improvements are amortized on a straight-line basis over the term of the lease. The pipeline is amortized on a straight-line basis over 25 years.

**Asset Retirement Obligation**

The Company recognizes the fair value of its asset retirement obligation (ARO) in the period in which it is incurred and when a reasonable estimate of fair value 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 amortized on a unit-of-production basis over the life of the reserve. The liability is increased each period due to the passage of time and the amount of accretion is charged against earnings for that period. Increases or decreases to the ARO can also result from revisions to the original timing or amount of the estimated undiscounted cash flows.

**Joint Venture Activities**

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

**Future Income Taxes**

The liability method is used in accounting for income taxes. Under this method, future income tax assets and liabilities are recognized based on differences between the financial reporting and tax bases of assets and liabilities, and measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period in which the change is substantively enacted. A valuation allowance is recorded against any future income tax asset if it is more likely than not that the asset will not be realized.

**Revenue Recognition**

Petroleum and natural gas sales are recognized when title passes from the Company to the purchaser. Pipeline revenue is recognized when the services have been provided.

**Stock Based Compensation Plan**

The fair value calculated related to stock options granted is deferred and charged against earnings, as stock compensation expense, over the vesting period of the stock options with a corresponding increase in contributed surplus.

Consideration paid to the Company upon the exercise of the stock options is recorded as an increase to share capital, and an adjustment is made to transfer to share capital the compensation expense previously recognized in contributed surplus for the specific stock options exercised.

The Company has not incorporated an estimated forfeiture rate for stock options in determining the stock option fair value in order to calculate its compensation expense, as the Company has assumed that all stock options granted will vest. Accordingly, forfeitures are accounted for as they occur and are treated as a change in estimate. The cumulative effect of the change on current and prior periods is recognized in the period of the change in estimate for unvested options that are forfeited or cancelled.

*(Significant Accounting Policies – continued)*

**Measurement Uncertainty**

The amounts recorded for depletion and depreciation of petroleum and natural gas properties, pipeline and equipment, the asset retirement obligation and the amount used for the ceiling test calculation are based on estimates of proven reserves, production rates, oil and natural gas prices, future costs and other relevant assumptions.

The amounts disclosed relating to the fair value of stock options issued are based on estimates of the expected lives of the options, expected stock price volatility, expected dividends and other relevant assumptions.

By their nature, these estimates are subject to measurement uncertainty, and the effect of changes in such estimates on the financial statements of future periods could be significant.

**Per Share Information**

Basic earnings per share are computed by dividing earnings by the weighted average number of common shares outstanding. Diluted earnings per share reflect the potential dilution that would occur if dilutive securities were exercised or converted to common stock. The dilutive effect of options and warrants and their equivalent is computed by application of the treasury stock method and the effect of convertible securities by the “if converted” method. Fully diluted amounts are not presented when the effect of the computations is anti-dilutive.

**Debt Instrument**

On issue of convertible debt instruments, the cost of the liability portion is initially calculated using the market interest rate for an equivalent non-convertible instrument. The remainder of the net proceeds is allocated to the equity conversion option, which is reported in equity. The liability element is subsequently reported at amortized cost. Amortization of the debt discount is recognized in the statement of operations over the duration of the debt instrument. The value of the equity conversion option is not changed in future periods.

**Financial Instruments**

Financial instruments of the Company carried on the balance sheet consists of cash, accounts receivable, accounts payable and accrued liabilities, bank loan and convertible debenture. The fair market value of cash, accounts receivable, accounts payable and accrued liabilities approximate their carrying value due to their short term to maturity. The Company's bank loan also approximates its carrying value as the credit facility bears interest at the prevailing interest rate. Cash is classified as held for trading and is measured at fair value; accounts receivable is classified as loans and receivables, and is measured at amortized cost. The financial liabilities are all classified as other liabilities and are measured at amortized cost.

At December 31, 2008, there were no significant differences between the carrying value of these financial instruments and their estimated fair value.

The Company does not hold any derivative financial instruments or any embedded derivatives and does not apply hedge accounting under Section 3865.

Comprehensive income consists of net earnings and other comprehensive income and represents the change in shareholders' equity, which results from transactions and events from sources other than the Company's shareholders. These transactions and events include changes in the currency translation adjustment and unrealized gains and losses resulting from changes in fair value of available for sale financial instruments and the effective portion of the change in fair value on any designated cash flow hedges.

*(Significant Accounting Policies – continued)*

### **Comparative Figures**

Prior year figures have been reclassified to conform to current year presentation.

### **3. Changes in Accounting Policies**

The Company adopted the following new CICA Handbook Sections, effective beginning January 1, 2008:

- Section 3862 – “Financial Instruments – Disclosures”, describes the required disclosure for the assessment of the significance of financial instruments for an entity’s financial position and performance and of the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks. This section and Section 3863, “Financial Instruments – Presentation” replaced Section 3861, “Financial Instruments – Disclosure and Presentation”.
- Section 3863 – “Financial Instruments – Presentation”, establishes standards for presentation of financial instruments and non-financial derivatives.
- Section 1535 – “Capital Disclosures”, establishes standards for disclosing information about an entity’s capital and how it is managed. It describes the disclosure requirements of the entity’s objectives, policies, and processes for managing capital, the quantitative data relating to what the entity regards as capital, whether the entity has complied with capital requirements, and, if it has not complied, the consequences of such non-compliance.
- Section 3031 – “Inventories” is harmonized with International Accounting Standards and provides additional guidance on the measurement and disclosure requirements for inventories. This new standard did not have an impact on the Company’s financial statements.
- The CICA has amended Section 1400, “General Standards of Financial Statement Presentation”, which include requirements to assess and disclose the Company’s ability to continue as a going concern. The adoption of this new section did not have an impact on the financial statements.

### **Future Accounting Pronouncements**

Section 3064 – “Goodwill and Intangible Assets”, will be adopted on January 1, 2009. This section establishes standards for the recognition, measurement, presentation, and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The Company is currently evaluating the impact of the adoption of this new Section on its financial statements but does not expect it to have a material impact on its financial statements.

Effective January 1, 2011, Section 1582, Business Combinations will provide the Canadian equivalent to International Financial Reporting Standard IFRS 3, “Business Combinations” and replace the existing Section 1581, Business Combinations. The new Section 1582 will apply prospectively to business combinations for which the acquisition date is on or after January 1, 2011. Earlier adoption is permitted as of the beginning of a fiscal year, in which case an entity would also early adopt Section 1601, Consolidated Financial Statements and Section 1602, Non-controlling Interests.

Effective January 1, 2011, Section 1601, Consolidated Financial Statements establishes standards for the preparation of consolidated financial statements and will replace the existing Section 1600, Consolidated Financial Statements. Earlier adoption is permitted as of the beginning of a fiscal year, in which case an entity would also early adopt Section 1582, Business Combinations and Section 1602, Non-controlling Interests.

Effective January 1, 2011, Section 1602, Non-controlling Interests establishes standards for a business combination. It is equivalent to the corresponding provisions of International Financial Reporting Standard IAS 27, “Consolidated and Separate Financial Statements”. Earlier adoption is permitted as of the beginning of a

*(Changes in Accounting Policies – continued)*

fiscal year, in which case an entity would also early adopt Section 1582, Business Combinations, and Section 1601, consolidated Financial Statements.

On January 2006, the CICA Accounting Standards Board (AcSB) adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, accounting standards in Canada for public companies are expected to converge with International Financial Reporting Standards (IFRS) by the beginning of 2011. The Company continues to monitor and assess the impact of convergence of Canadian GAAP and IFRS.

The Company is currently evaluating the impact of the adoption of the above new accounting standards on its Consolidated Financial Statements.

#### **4. Business Acquisitions**

- (a) On September 28, 2007 Arrow acquired all the outstanding shares of Castle Rock Petroleum Ltd., a public company trading on the TSX Venture Exchange. Arrow issued 4,180,325 common shares valued at \$1,755,737 before transaction costs. Arrow exchanged one Arrow Common Share for every five Castle Rock "A" Shares and one Arrow Common Share for each one half of a Castle Rock B Share.

The acquisition has been accounted for using the purchase-price method. Management has estimated the fair market value on September 28, 2007 based on currently available information as follows:

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Consideration:		
Common Shares	\$	1,755,737
Transaction costs		54,598
		<hr/>
		\$ 1,810,335
<hr/>		
Net Assets Received at Estimated Fair Value		
Cash	\$	381,745
Accounts receivable		381,083
Prepaid		29,827
Property, plant & equipment		1,559,127
Accounts payable		(453,556)
Asset retirement obligation		(87,891)
		<hr/>
		\$ 1,810,335
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- (b) Arrow and Discovery Drilling Funds 2005 Oil and Gas Limited Partnership (Dublin Resources Inc.) entered into a purchase agreement dated June 15, 2008, whereas the partnership transferred 67.84% of its common shares to Arrow for cash consideration of \$398,906. This acquisition closed on September 12, 2008.

Arrow and Discovery Drilling Funds V Development Limited Partnership (1078287 Alberta Ltd.) entered into a purchase agreement dated June 15, 2008, whereas the partnership transferred all of its common shares to Arrow for cash consideration of \$82,029. This acquisition closed on September 12, 2008.

Arrow and Discovery Drilling Funds VI Limited Partnership (1125048 Alberta Ltd.) entered into a purchase agreement dated June 15, 2008, whereas the partnership transferred all of its common shares to Arrow for cash consideration of \$109,336. This acquisition closed on September 12, 2008.

The acquisitions have been accounted for using the purchase price method. Management has concluded the fair market values of the net assets acquired are as follows:

*(Business Acquisitions – continued)*

Consideration:		
Cash	\$	590,271
Net assets received at estimated fair value		
Cash	\$	104,364
Accounts receivable		8,123
Property, plant, & equipment		624,508
Accounts payable		(12,828)
Asset retirement obligation		(5,607)
Non-controlling interest		(128,289)
	\$	590,271

## 5. Property and Equipment

	December 31, 2008		
	Cost	Accumulated Depletion and Depreciation and Impairments	Net Book Value
Petroleum and natural gas properties	\$ 27,439,331	\$ 12,139,459	\$ 15,299,872
Pipeline	3,740,798	2,040,790	1,700,008
Office equipment and furniture	155,640	66,983	88,657
	<b>\$ 31,335,769</b>	<b>\$ 14,247,232</b>	<b>\$ 17,088,537</b>
December 31, 2007			
	Cost	Accumulated Depletion and Depreciation	Net Book Value
Petroleum and natural gas properties	\$ 23,032,566	\$ 6,663,254	\$ 16,369,312
Pipeline	3,740,798	112,225	3,628,573
Office equipment and furniture	121,045	37,148	83,897
	<b>\$ 26,894,409</b>	<b>\$ 6,812,627</b>	<b>\$ 20,081,782</b>

General and administrative expenses totalling \$119,839 have been capitalized in 2008 (2007 - \$32,859). Petroleum and natural gas properties as at December 31, 2008 include costs of \$1,314,836 (2007 - \$2,353,420) relating to undeveloped land, which has been excluded from the amounts subject to depletion.

At December 31, 2008, \$1,778,942 (2007 - \$Nil) of impairment expense has been recognized relating to the pipeline.

At December 31, 2008, a ceiling test determined that capitalized costs exceeded the discounted future cash flows from production of proven and probable reserves and therefore an impairment of \$2,884,277 was recognized (2007 - \$Nil).

*(Property and Equipment – continued)*

The future prices used in the ceiling test calculation are based on the December 31, 2008 benchmark commodity price forecast of our independent reserve evaluators, adjusted for the Company's quality and transportation differentials as follows:

Year	Price Forecast	
	Oil (CDN \$/Bbl) Edmonton Par	Natural Gas (CDN \$/Mcf) AECO - C
2009	65.35	6.82
2010	72.78	7.56
2011	79.95	7.84
2012	86.57	8.38
2013	94.97	9.20
2014	96.89	9.41
2015	98.85	9.62
2016	100.84	9.83
2017	102.88	10.05
2018	104.96	10.27
2019	107.08	10.50

*Escalation rate of 2.0% thereafter*

## 6. Asset Retirement Obligation

The total future asset retirement obligation was estimated by management based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon the wells and facilities, and the estimated timing of the costs to be incurred in future periods. The Company has estimated the net present value of its total asset retirement obligation to be \$1,340,872 as at December 31, 2008 (2007 - \$1,081,877) based on a total future liability of \$5,915,966 (2007 - \$4,855,639).

These payments are expected over the next 20 years with the majority of costs incurred between 2010 and 2026. An inflation factor of 2% has been applied to the estimated asset retirement cost at December 31, 2008 and December 31, 2007. A credit-adjusted risk-free rate of 8% was used to calculate the fair value of the asset retirement obligations at December 31, 2008 and 2007. A reconciliation of the asset retirement obligation is provided in the following table:

	December 31, 2008	December 31, 2007
Balance, beginning of year	\$ 1,081,877	\$ 234,050
Increase in obligations	191,233	223,615
Pipeline	–	563,666
Liabilities settled	(43,042)	–
Accretion expense	110,804	60,546
Balance, end of year	\$ 1,340,872	\$ 1,081,877

## 7. Share Capital

	<b>Number of Shares</b>	<b>Amount</b>
Balance, December 31, 2006	14,138,914	\$ 9,743,897
Shares deposited into treasury	(50,000)	(34,500)
Shares issued for acquisition	4,180,325	1,755,737
Units issued for private placement		
shares issued, net of costs	5,714,488	1,181,273
Shares issued on a flow through basis, net of cost basis	1,250,000	480,000
Note receivable on flow through issue	–	(100,000)
Shares issued for P&NG acquisition	2,000,000	1,100,000
Balance, December 31, 2007	27,233,727	\$ 14,126,407
Shares issued on a flow through basis	3,250,000	650,000
Provision for share purchase loan (Note 13 (c))	–	100,000
Value assigned to warrants issued on flow-through basis	–	(144,178)
Future income taxes on renunciation of flow through shares issued	–	(147,500)
Share issue costs	–	(11,978)
Balance, December 31, 2008	30,483,727	\$ 14,572,751
	<b>Number of Warrants</b>	<b>Amount</b>
Units issued for private placement		
Broker warrants	285,714	\$ 46,286
Warrants	2,857,244	463,731
Warrants issued for P&NG acquisition	2,000,000	102,259
Balance, December 31, 2007	5,142,958	612,276
Expiry of warrants	(2,000,000)	(102,259)
Value attributed to warrants issued for flow-through	3,250,000	144,178
Balance, December 31, 2008	6,392,958	654,195
Total Share Capital, December 31, 2008		\$ 15,226,946

### (a) Warrants

In 2007, Arrow issued 5,714,488 units (“Units”) at a price of \$0.35 per Unit for gross proceeds of \$2,000,020. Each Unit is comprised of 1 common share (“Common Share”) and 1/2 Common Share purchase warrant. Each whole warrant entitles the holder to purchase 1 additional Common Share at a price of \$0.50 per Common Share for a period of 24 months following the date of closing, subject to certain accelerated expiration conditions.

In connection with the private placement in 2007, Arrow issued Broker Options exercisable for a total of 571,428 units (“Broker Unit”) at a price of \$0.35 for a period of 24 months from the closing date. Each Broker Unit issued is comprised of 1 Common Share and 1/2 Common Share purchase warrant. As at December 31, 2008, there are 571,428 Broker Options outstanding that if exercised, will result in the issue of 571,428 Common Shares and the 285,714 Broker Warrants become exercisable at a price of \$0.50. The Company used the Black-Scholes pricing model to determine the fair value of the warrants with the following assumptions: risk free rate 4.5%, estimated life of 5 years, volatility of 90% and dividend yield of Nil.

In 2008, 2,000,000 warrants expired, which were issued in connection with an asset acquisition in 2007. The fair value of these warrants of \$102,259 was credited to contributed surplus on the date of expiration.

*(Share Capital – continued)*

On November 10, 2008, the Company completed a private placement for \$650,000 of 3,250,000 units at a price of \$0.20 per unit. Each unit is comprised of 1 flow-through common share and 1 common share warrant. Each warrant entitles the holder to purchase 1 additional common share of Arrow at a price of \$0.30 per common share for a period of 2 years following the date of closing. The fair value of these warrants was determined to be \$0.04 per warrant at the grant date using the Black-Scholes pricing model with the following assumptions: risk free rate 3.3%, estimated life of 2 years, volatility of 60% and dividend yield of Nil.

*(b) Stock Options*

Under the Company's stock option plan, options may be granted in such numbers and with such vesting provisions as the Board of Directors may determine. At the time an option is granted, the Board will determine the exercise price of the option. The aggregate number of shares that may be available for issuance, from time to time, under the plan shall not exceed 20% of outstanding shares. In addition, the aggregate number of shares so available for issuance under the plan to any one person in any 12 month period shall not exceed 5% of the issued shares calculated at the time of grant of the option. Options have a term of 5 years, and vest over three years.

In 2008, the Company granted 4,430,000 options with a weighted average exercise price of \$0.21 and a fair value of \$0.09 per option. The fair value of options granted during 2008 and 2007 was estimated at the date of grant using the Black-Scholes Option Pricing Model with the following assumptions:

	<b>2008</b>	2007
Risk-free interest rate	<b>3.3%</b>	4.5%
Estimated hold period prior to exercise (years)	<b>3</b>	5
Volatility in the price of the company's common shares	<b>60%</b>	90%
Dividend yield	<b>Nil</b>	Nil

In the Statement of Operations, the Company recorded stock-based compensation expense of \$404,084 for the year ended December 31, 2008 (2007 - \$288,833). Of this amount, \$304,084 relates to stock options and \$100,000 relates to the share purchase loan provision (Note 13 (c)).

	Number of Options	Weighted average exercise price
Balance, December 31, 2006	1,210,000	\$ 0.45
Forfeited during the period	(635,000)	(0.45)
Granted during the period	1,043,750	0.40
Broker options issued	571,428	0.35
Balance, December 31, 2007	2,190,178	\$ 0.40
Granted during the period	4,430,000	\$ 0.21
Forfeited during the period	(977,500)	(\$ 0.35)
Balance, December 31, 2008	5,642,678	\$ 0.27

*(Share Capital – continued)*

The following table summarizes information about stock options outstanding as at December 31, 2008:

Exercise Price	Options Outstanding	Exercisable	Weighted Average Years to Expiry
\$0.45	275,000	275,000	3.00
\$0.45	131,250	87,500	3.50
\$0.38	625,000	625,000	3.57
\$0.35	571,428	571,428	1.00
\$0.22	1,490,000	1,163,333	4.40
\$0.20	450,000	450,000	4.44
\$0.17	100,000	100,000	4.59
\$0.20	2,000,000	666,666	4.67
Total	5,642,678	3,938,927	3.65

*(c) Contributed Surplus*

A summary of the change in the Company's contributed surplus balance for the years ended December 31, is as follows:

	2008	2007
Balance, beginning of year	\$ 6,306,827	\$ 482,368
Acquisition of oil and gas assets	–	5,389,125
Expiry of warrants	102,259	–
Cancellation of shares	–	34,500
Stock-based compensation expense	304,084	288,833
Fair value of common shares included in broker units	–	112,001
Balance, end of year	\$ 6,713,170	\$ 6,306,827

## 8. Bank Loan

At December 31, 2008, the Company had available an operating credit facility of up to \$6,500,000. Of this amount, the Company had drawn \$5,805,000 on its facility and had a bank overdraft amount of \$259,437. The facility is secured by a \$10,000,000 debenture over all present and after acquired petroleum and natural gas interests. Interest on this facility is charged monthly at the bank's prime rate plus 50 basis points. At December 31, 2008, the effective rate charged on the loan facility was 4.0%.

The Company is subject to a covenant on its operating credit facility with its lender to maintain its working capital ratio at a 1 to 1 level, as defined in the credit agreement. At December 31, 2008, Arrow was not in compliance with its debt covenants relating to working capital. The lender has acknowledged that the Company was in default of the established working capital covenant with a ratio of 0.81:1, but has not waived this breach, and the facility is callable at anytime.

Subsequent to December 31, 2008, the lender amended certain terms of the credit facility (see Note 15).

## 9. Income Taxes

The future income tax recovery for 2008 and 2007 varies from the amount that would be computed by applying the combined federal and provincial income tax rates of 29.5% (2007 – 32.12%) to the loss before income taxes as shown below:

	December 31, 2008	December 31, 2007
Computed income tax recovery	\$ (2,116,987)	\$ (1,077,207)
Changes resulted from:		
Stock compensation and other permanent differences	126,164	98,688
Changes to tax pools	774,051	-
Rate adjustment and other	322,147	58,549
Change in valuation allowance	230,634	-
	<u>\$ (663,991)</u>	<u>\$ (919,970)</u>

The major components of the future income tax asset (liability) at December 31, 2008 and December 31, 2007 using the combined federal and provincial income tax rates of 25.00% based on reversal of the future income tax liability (2007 – 25.00%) are as follows:

	December 31, 2008	December 31, 2007
Property and equipment	\$ (1,279,413)	\$ (953,054)
Share issue costs deductible for tax purposes	43,459	65,580
Asset retirement obligation	335,218	270,469
Non-capital losses carried forward	1,323,370	292,515
	<u>\$ 422,634</u>	<u>\$ (324,490)</u>
Valuation allowance	(230,634)	-
	<u>\$ 192,000</u>	<u>\$ (324,490)</u>

## 10. Financial Risk and Capital Management

The Company is exposed to financial risk in a range of financial instruments including accounts receivable, accounts payable, and a bank revolving credit facility. The Company manages its exposure to financial risks by operating in a manner that minimizes its exposure to the extent practical. The main financial risks affecting the Company are discussed below.

### **Credit Risk**

Credit risk arises when a failure by counter parties to discharge their obligation could reduce the amount of future cash inflows from financial assets on hand at the balance sheet date. A majority of the Company's financial assets at the balance sheet date arise from crude oil, natural gas liquids, and natural gas sales. Industry standard dictates that commodity sales are settled on the 25th day of the month following the month of production. The Company markets its oil and natural gas to several marketers so that the exposure to any one entity is minimized. In addition, when joint operations are conducted on behalf of a joint venture partner relating to capital expenditures, costs of such operations are paid for in advance to the Company by way of a cash call by the partner of the operation being conducted.

The Company assesses quarterly if there has been any impairment of the financial assets of the Company. During the year ended December 31, 2008, the Company has provided for the share purchase loan (Note 13 (c)). The Company does not have any significant credit risk exposure to any single counterparty or any group of counterparties having similar characteristics.

*(Financial Risk and Capital Management – continued)*

The maximum exposure to credit risk is represented by the carrying amount on the balance sheet. There are no material financial assets that the Company considers past due.

**Market Risk**

*Interest Rate Risk*

Interest rate risk refers to the risk that the value of a financial instrument or cash flows associated with the instrument will fluctuate due to changes in market interest rates. The Company is exposed to interest rate risk as it borrows funds at floating interest rates as disclosed in Note 8. The Company currently does not use interest rate hedges or fixed interest rate contracts to manage the Company's exposure to interest rate fluctuations.

Assuming all other variables remain constant, a 1% increase or decrease in interest rates would have impacted the cash flows of the Company during the twelve month period ended December 31, 2008 by approximately \$60,644.

**Liquidity Risk**

Liquidity risk includes the risk that, as a result of the Company's operational liquidity requirements:

- The Company will not have sufficient funds to settle a transaction on the due date;
- The Company will be forced to sell financial assets at a value which is less than what they are worth; or
- The Company may be unable to settle or recover a financial asset at all.

The Company's operating cash requirements, including amounts projected to complete the Company's existing capital expenditure program, are continuously monitored and adjusted as input variables change. These variables include, but are not limited to, available bank lines, oil and natural gas production from existing wells, results from new wells drilled, commodity prices, cost overruns on capital projects, and regulations relating to prices, taxes, royalties, land tenure, allowable production, and availability of markets. As these variables change, liquidity risks may require the Company to conduct equity issues or obtain project debt financing. The Company also mitigates liquidity risk by maintaining an insurance program to minimize exposure to insurable losses. Currently, the Company's maturities of financial liabilities as at December 31, 2008 are within one year for accounts payable, accrued liabilities, the credit facility, and two years for the convertible debenture. Given the balances, with the exception of the convertible debenture, are due in the next twelve months there is a risk, as discussed in Note 1, that the Company may not be able to meet its obligations as they come due.

**Capital Risk Management**

The Company's objective when managing capital is to safeguard its ability to continue as a going concern, so that it can continue to provide returns to shareholders and benefits for other stakeholders. The Company manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. The Company's objective is met by retaining adequate equity to guard against the possibility that cash flows from assets will not be sufficient to meet future cash flow requirements. The Board of Directors does not establish quantitative return on capital criteria for the Company, but rather promotes year over year sustainable growth in net income and cash flow from operating activities.

*(Financial Risk and Capital Management – continued)*

The Company defines capital as total cash, debt, convertible debenture, and total equity.

	<b>December 31, 2008</b>	December 31, 2007
Cash	\$ 96,921	\$ 155,692
Debt	(6,064,437)	(3,037,838)
Convertible debenture	(162,827)	-
Total equity	(8,779,658)	(15,012,107)
Total capital	<b>\$ (14,910,001)</b>	<b>\$ (17,894,253)</b>

The Company is subject to a covenant on its operating credit facility with its lender to maintain its working capital ratio at a 1 to 1 level, as defined in the credit agreement. At December 31, 2008, the Company's working capital ratio was 0.81:1. The lender has not waived this breach, and the debt is callable at anytime (see Note 15).

Working Capital Ratio of 0.81:1 is calculated as follows:

Current Assets	\$ 1,018,218
+ undrawn availability under bank loan	\$ 435,563
	<b>\$ 1,453,781</b>
divided by Current Liabilities, excluding any amount drawn under bank loan or debenture:	<b>\$ 1,798,193</b>

**Commodity Price Risk**

The Company is exposed to fluctuations in commodity prices for crude oil, natural gas and natural gas liquids. Commodity prices are affected by many factors including supply and demand. The Company monitors these risks and when appropriate, utilizes financial instruments to manage its exposure to these risks. The Company currently does not use financial hedges to manage the Company's exposure to commodity price fluctuations and therefore has no related financial instruments.

**11. Commitments and Contingencies**

(a) The Company has remaining lease commitments for office space of \$23,233 and \$757,302 which expire on February 28, 2010 and July 1, 2012, respectively.

(b) In 2008, the Company committed to renounce \$650,000 of exploration expense pursuant to a flow-through share issue agreement completed November 10, 2008. The Company has until December 31, 2009 to incur these exploration expenditures. As at December 31, 2008, the Company had \$650,000 left to spend.

## 12. Supplementary Cash Flow Information

The following table details the components of non-cash working capital for operating and investing activities:

	December 31, 2008	December 31, 2007
Accounts receivable	\$ 998,240	\$ (1,366,161)
Deposits and prepaid expenses	91,108	(108,970)
Accounts payable and accrued liabilities	(798,318)	1,701,996
	<b>291,030</b>	226,865
Operating	<b>314,770</b>	(119,442)
Investing	<b>(23,740)</b>	346,307
	<b>\$ 291,030</b>	\$ 226,865

## 13. Related Party Transactions

- (a) For the year ended December 31, 2008, the Company incurred \$140,532 (2007 - \$13,574) in legal fees with a balance of \$32,298 (2007 - \$13,574) included in accounts payable. A partner of the legal firm is a Director of the Company.
- (b) At December 31, 2008, the Company has an amount payable to the Peavine Métis Settlement in the amount of \$36,667 (2007 - 71,899), to the Métis Settlement General Council in Trust for Peavine for \$27,621 (2007 - \$165,104), and \$11,634 (2007 - \$146,307) to the Métis Settlement General Council. These payables relate to revenues earned on land from participation in joint ventures. A company that is a shareholder of Arrow is controlled by the Peavine Métis Settlement.
- (c) At December 31, 2007, the Company entered into a loan agreement with the former President of the Company to provide a loan in the amount of \$100,000 for the purchase of flow-through shares of the Company. In 2008, the share purchase loan was provided for (Note 7).
- (d) During 2008, the Company issued a convertible debenture (Note 14). Certain companies, which are controlled by the President of Arrow, were the initial holders of the convertible debenture. This convertible debenture was subsequently assigned to a family member of the President. The debenture agreement replaced a \$200,000 liability due to these companies from a previous sale of petroleum natural gas properties to Arrow in 2007. These transactions were completed prior to the President becoming a director and officer of the Company.
- (e) During 2008, certain officers and a director of the Company completed a private placement for \$650,000 of 3,250,000 units at a price of \$0.20 per unit. Each unit is comprised of 1 flow-through common share and 1 common share warrant. Each warrant entitles the holder to purchase 1 additional common share of Arrow at a price of \$0.30 per common share for a period of 2 years following the date of closing (Note 7).

#### 14. Convertible Debenture

During 2008, Arrow issued \$200,000 principal amount of 8.0% Convertible Secured Debenture. The debenture may be converted to share capital at any time at \$0.25 per common share. The debenture matures on June 25, 2010. The debenture is a financial instrument that contains both a liability and equity component. The liability component and the equity component were presented separately, as determined at initial recognition. The Company has valued the equity component of this debenture using the Black-Scholes fair value model with the following assumptions: risk-free rate 3.3%, estimated life 2 years, volatility of 60% and dividend yield of Nil. The difference between the proceeds of the issued convertible debentures and the fair value of the equity component is assigned to the liability component. At the time, the resulting liability component was \$150,827 and the equity component was \$49,173. Total accretion expense related to the liability component of the convertible debenture is \$12,000. The carrying value of the debenture will be accreted up to its face value over the term to maturity.

	<b>December 31, 2008</b>
Convertible Debenture issued in year	<b>\$ 200,000</b>
Equity component	<b>(49,173)</b>
Convertible Debenture, debt component	<b>150,827</b>
Accretion expense	<b>12,000</b>
Convertible Debenture, December 31, 2008	<b>\$ 162,827</b>

The Company is subject to a covenant on the debenture effecting a default should the Company be in default on the operating credit facility with its primary lender. At December 31, 2008, Arrow was not in compliance with its debt covenants relating to working capital. Notwithstanding that no notice of default has been issued by the debenture holder, the debenture is callable at anytime.

#### 15. Subsequent Event

On January 27, 2009 the Company and its lender executed an extension agreement amending the terms of the operating credit facility thereby reducing the borrowing base to \$4,000,000, increasing the interest rate to prime +3% and amending certain lending covenants. In conjunction with the extension agreement, the lender issued a notice of intention to enforce security but agreed to forebear from exercising its enforcement rights until April 30, 2009 in exchange for fees totaling \$80,000.