

Emerald Bay Energy Inc.
Financial Statements
For the years ended December 31, 2003 and 2002

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Auditors' Report

To the Shareholders of Emerald Bay Energy Inc.

We have audited the balance sheets of Emerald Bay Energy Inc. as at December 31, 2003 and 2002 and the statements of operations 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 financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

BDO Dunwoody LLP

Chartered Accountants

Calgary, Alberta
May 3, 2004
(except for Note 17(c), which is dated as of May 18, 2004)

**Emerald Bay Energy Inc.
Balance Sheets**

As at December 31

	2003	2002 (restated-note 5)
Assets		
Current		
Cash and short term investments	\$ 964,995	\$ 37,089
Accounts receivable (Note 14)	192,197	257,901
Prepaid expenses and deposits	57,280	15,580
Due from related parties (Note 7)	12,282	79,390
	1,226,754	389,960
Due from related parties (Note 7)	215,735	349,311
Property and equipment (Note 4)	618,390	446,585
License fee (Note 11(a))	65,882	70,000
Future income taxes (Note 9)	-	133,984
	\$ 2,126,761	\$ 1,389,840

Liabilities and Shareholders' Equity

Current

Bank loan (Note 6)	\$ -	\$ 412,500
Accounts payable and accrued liabilities	532,771	386,906
	532,771	799,406
Future taxes (Note 9)	146,000	-
Asset retirement obligation (Note 5)	61,204	19,517
	739,975	818,923
Contingencies (Note 11)		
Shareholders' equity		
Share capital (Note 8(b))	1,949,425	878,104
Warrants (Note 8(f))	42,400	-
Deficit	(605,039)	(307,187)
	1,386,786	570,917
	\$ 2,126,761	\$ 1,389,840

Signed "Shelby D. Beattie"

Shelby D. Beattie Director

Signed "Richard D. Tingle Q.C."

Richard D. Tingle Q.C. Director

Richard D. Tingle Q.C.



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

Emerald Bay Energy Inc.
Statements of Operations and Deficit

For the years ended December 31

2003

2002

(restated-note 5)

Revenue

Petroleum and natural gas sales	\$ 1,324,794	\$ 847,270
Royalties	(323,628)	(224,575)
Alberta Royalty Tax Credits	28,425	48,819
Gain (loss) on futures contracts	-	(52,664)
	<u>1,029,591</u>	<u>618,850</u>

Expenses

Operating	284,526	189,265
General and administrative (Note 7(b)(i))	672,805	629,583
Research and development (Note 7(b)(iii))	275,256	17,135
Depletion and amortization	115,511	67,185
Bad debts (Note 11(c))	50,038	-
Interest	17,605	25,121
Accretion	4,053	1,362
	<u>1,419,794</u>	<u>929,651</u>

Loss from operations

(390,203) (310,801)

Other income

Gain on sale of property and equipment	-	25,023
Interest	15,351	42,757
	<u>15,351</u>	<u>67,780</u>

Loss before income taxes

(374,852) (243,021)

Income taxes (recovery) (Note 9)

Current	-	-
Future	(77,000)	(13,089)
	<u>(77,000)</u>	<u>(13,089)</u>

Loss for the year

(297,852) (229,932)

Deficit, beginning of year

(307,187) (74,284)

Adjustment to reflect change in accounting policy
(Note 5)

1,273

Purchase price of common shares repurchased
in excess of book value (Note 8(c))

- (4,244)

Deficit, end of year

\$ (605,039) \$ (307,187)

Loss per common share (Note 8(e))

\$ (0.044) \$ (0.036)

Weighted average number of shares

6,727,306 6,356,228

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



Emerald Bay Energy Inc.
Statements of Cash Flows

For the years ended December 31

2003

2002
(restated-note 5)

Cash flows from operating activities

Loss for the year	\$ (297,852)	\$ (228,659)
Adjustments for:		
Depletion, amortization and accretion	119,564	67,274
Amortization of license fee	4,118	-
Future income taxes	(77,000)	(13,089)
Gain on sale of property and equipment	-	(25,023)

Cash flow from operations

	(251,170)	(199,497)
Changes in non-cash operating balances		
Accounts receivable	65,704	(143,141)
Prepaid expenses and deposits	(41,700)	3,848
Accounts payable and accrued liabilities	145,807	180,706
	<u>(81,359)</u>	<u>(158,084)</u>

Cash flows from investing activities

Purchases of property and equipment	(277,749)	(135,102)
Proceeds on disposition of property and equipment	28,052	37,500
	<u>(249,697)</u>	<u>(97,602)</u>

Cash flows from financing activities

Bank loan advances (repayment)	(412,500)	187,500
Advances (repayments) from (to) related parties	200,742	(39,222)
Issuance of share capital, net of issue costs	1,470,720	12,700
	<u>1,258,962</u>	<u>160,978</u>

Increase (decrease) in cash and short term investments

	927,906	(94,708)
Cash and short term investments, beginning of year	37,089	131,797

Cash and short term investments, end of year

	\$ 964,995	\$ 37,089
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Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2003 and 2002

1. Nature of Operations

Emerald Bay Energy Inc. (the "Company") was incorporated under the Business Corporations Act of Alberta on May 9, 1997. The Company is engaged in the exploration for and development of petroleum and natural gas properties principally in Alberta and is developing a lateral drainhole drilling technology.

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities and commitments in the normal course of business. While the Company has approximately \$693,983 of working capital, the Company is committed to spending \$1.4 million in flow through share obligations for oil and gas exploration in 2004, therefore they will need to be able to finance the difference or obtain additional financing. These statements also assume the collection of the \$215,735 long term portion of the amounts due from related parties (Note 7). As discussed in Note 11(c), the Company is defending certain Alberta Royalty tax re-assessments which, if unsuccessful, could have a serious impact on the Company's cash flows.

Management are committed to raising additional capital to meet exploration and operating obligations (Note 17). While management has been successful in the past surrounding financing, there is no assurance that sufficient funds will be raised in the future.

The Company's ability to continue as a going concern is dependent upon the Company continuing to achieve profitable results, the ability to continue to raise capital for oil and gas exploration and a successful resolution of the tax appeals. Future lateral drainhole drilling operations are dependent on successful testing results and access to additional funding.

2. Summary of Significant Accounting Policies

The financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The financial statements have, in management's opinion, been properly prepared using careful judgement with reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

a) Property and equipment

The Company follows the full cost method of accounting for oil and gas operations whereby all costs of exploring for and developing oil and gas reserves are initially capitalized. Such costs include land acquisition costs, geological and geophysical expenses, carrying charges on non-producing properties, costs of drilling and overhead charges directly related to acquisition and exploration activities.

Costs capitalized, together with the costs of production equipment, are depleted on the unit-of-production method based on the estimated gross proved reserves. Petroleum products and reserves are converted to equivalent units of natural gas at approximately 6,000 cubic feet to 1 barrel of oil.

December 31, 2003 and 2002

2. Summary of Significant Accounting Policies - continued

b) Property and equipment - continued

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion calculations.

Proceeds from the sale of petroleum and natural gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would significantly alter the rate of depletion.

In applying the full cost method, the Company calculates a ceiling test whereby the carrying value of property and equipment is compared to the sum of the undiscounted cash flows expected to result from the future production of proved reserves and the sale of unproved properties. Cash flows are based on third party quoted forward prices, adjusted for transportation and quality differentials. Should the ceiling test result in an excess of carrying value, the Company would then measure the amount of impairment by comparing the carrying amounts of property and equipment to an amount equal to the estimated net present value of future cash flows from proved plus probable reserves and the sale of unproved properties. The Company's risk-free interest rate is used to arrive at the net present value of the future cash flows. Any excess carrying would be recorded as a permanent impairment.

Furniture and equipment are carried at cost and amortized over the estimated useful lives of the asset on a straight-line basis over three to five years.

c) Joint venture operations

The majority of the Company's petroleum and natural gas exploration activities are conducted jointly with others. These financial statements reflect only the Company's proportionate interest in such activities.

d) Asset retirement obligations

In March 2003, the Canadian Institute of Chartered Accountants ("CICA") introduced new recommendations for the recognition, measurement and disclosure of liabilities for asset retirement obligations and the associated asset retirement costs. Effective fiscal 2003 the Company adopted this standard with retroactive restatement of prior periods. This standard applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development or normal use for the assets and requires that a liability for an asset retirement obligation be recognized when incurred, recorded at fair value and classified as a liability in the balance sheet. When the liability is initially recorded, the entity will capitalize the net present value of the cost and increase the carrying value of the related long-lived asset. Asset retirement obligations represent future liabilities, and, as a result, accretion expense will be accrued on this liability until the obligation is satisfied. At the same time, the capitalized cost will be depleted over the estimated useful life of the related asset. At settlement date, the entity will settle the obligation for its recorded amount or recognize a gain or loss upon settlement.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2003 and 2002

2. Summary of Significant Accounting Policies - continued

e) Revenue recognition

Revenue associated with the sale of crude oil, natural gas and natural gas liquids is recognized when title passes to the purchaser, normally at the pipeline delivery point for natural gas, and at the wellhead for crude oil. Revenue recorded is net of transportation costs.

f) Flow-through equity instruments

Expenditure deductions for income tax purposes related to exploratory activities funded by flow-through share/warrants arrangements are renounced to investors in accordance with income tax legislation. A future tax liability is recognized upon the renunciation of tax pools and share capital is reduced by the estimated costs of the renounced tax deductions. The Company has early adopted the new accounting standard, EIC 146, in tax affecting the flow through shares before renunciations are effected.

g) Financial instruments

The Company carries a number of financial instruments. It is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.

The Company periodically utilizes custom financial instruments to reduce its exposure to fluctuations in commodity prices. Such instruments are not used for trading purposes. Gains and losses on commodity price instruments are included in oil and gas sales on settlement.

h) Measurement uncertainty

The amounts recorded for depletion and amortization of petroleum and natural gas properties and equipment and the provision for asset retirement obligations are based on estimates. The ceiling test is based on estimates of proved reserves, production rates, oil and 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 and estimates in future periods could be significant.

The financial statements include accruals based on the terms of existing joint venture agreements. Due to varying interpretations of the definition of terms in these agreements the accruals made by management in this regard may be significantly different from those determined by the Company's joint venture partners. The effect on the financial statements resulting from such adjustments, if any, will be reflected prospectively.

i) Future income taxes

The liability method is used in accounting for income taxes. Under this method, future tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities, and measured using substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse.

j) Cash and short-term investments

Cash and short-term investments include bank balances and all highly liquid instruments purchased with an original maturity of three month or less.

December 31, 2003 and 2002

2. Summary of Significant Accounting Policies – continued

k) Stock based compensation plan

Effective January 1, 2003, the Company prospectively adopted the new Canadian accounting standard with respect to stock based compensation. The standard requires that the fair value method of accounting be applied for stock options awarded to directors, officers and employees after January 1, 2003. Compensation expense is recorded over the vesting period using the estimated fair value of the option on the grant date. Consideration paid on the exercise of stock options is recorded as share capital.

l) Per share amounts

Basic earnings (loss) per common share per common share are computed by dividing earnings (loss) by the weighted average number of common shares outstanding for the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options and other dilutive instruments, in accordance with new standards approved by the Canadian Institute of Chartered Accountants.

m) License fee

License fee relates to patent rights of certain lateral drainhole drilling technology. Commencing in 2003 this license fee will be amortized over the remaining life of the patent (17 years). If the license fee is determined not to have value, it will be written off in the period the determination is made.

n) Research and development

The Company is involved in the research, development and ultimate production of oil field tools. To date, all direct and indirect costs associated with the development of these tools have been expensed as incurred. The Company will commence capitalization and deferral of these costs once technological feasibility is established and criteria for deferral are met.

Investment tax credits are accrued when qualifying expenditures are made and there is reasonable assurance that the credits will be realized. The Company accounts for the investment tax credits using the cost reduction method.

3. Change in Accounting Policy

Effective December 31, 2003, the Company adopted Accounting Guideline 16 Oil and Gas Accounting – Full Cost. This Guideline deals with the application of the full cost method of accounting for oil and gas exploration and development activities. Had the Company not adopted the Guideline, upon application of the ceiling test the Company's carrying value would not have been in excess of the ceiling value.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2003 and 2002

4. Property and Equipment

	December 31, 2003			December 31, 2002		
	Cost	Accumulated Depletion and Amortization	Net Book Value	Cost	Accumulated Depletion and Amortization	Net Book Value
Petroleum and natural gas properties	\$ 1,191,970	\$ 600,350	\$ 591,620	\$ 921,064	\$ 495,560	\$ 425,504 (restated – Note 5)
Furniture and equipment	62,370	35,600	26,770	50,077	28,996	21,081
	<u>\$ 1,254,340</u>	<u>\$ 635,950</u>	<u>\$ 618,390</u>	<u>\$ 971,141</u>	<u>\$ 524,556</u>	<u>\$ 446,585</u>

At December 31, 2003, the Company applied a ceiling test to its oil and gas assets using a gas price of \$6.03 (2002 - \$6.04) per mcf on gas and an oil price of \$39.09 (2002 - \$47.59) per barrel. The application of this test resulted in an excess ceiling value over the net book value. The Company did not capitalize any general and administrative costs during 2003 and 2002. No unproved property costs have been deducted from costs subject to depletion and amortization in 2003 and 2002.

5. Asset Retirement Obligation

The Company adopted the CICA's new recommendation on asset retirement obligations ("ARO") for fiscal 2003, with retroactive restatement of prior periods. At the date of drilling/acquisition the Company identified obligations related to oil and gas properties and recorded a liability equal to the present value of expected future assets retirement obligations. The total future ARO 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 ARO to be \$61,204 as a December 31, 2003 based on a total future liability of \$160,031 and incorporated the Company's credit-adjusted risk-free interest rate of 7.5%. These payments are expected to be made over the next 10 years.

The following table reconciles the company's asset retirement obligations:

	2003	2002
Asset retirement obligation, beginning of period	\$ 19,517	\$ 18,155
New liabilities incurred	37,634	-
Liabilities settled	-	-
Accretion expense	4,053	1,362
Asset retirement obligation, end of period	<u>\$ 61,204</u>	<u>\$ 19,517</u>

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2003 and 2002

6. Bank Loan

The Company has a \$525,000 (2002 - \$525,000) revolving production loan facility, of which \$nil (2002 - \$412,500) plus accrued interest, has been drawn at December 31, 2003. Interest is calculated at the bank's prime rate plus 1.5% (2002 – prime rate plus 1.5%).

Security for the loan consists of a revolving line of credit agreement, a general security agreement over all present after acquired property, a \$2 million debenture at the bank prime rate plus 2% over all oil and gas properties and an assignment of any long-term contracts.

7. Due From Related Parties and Related Party Transactions

a) The following amounts are due by related parties:

	<u>2003</u>	<u>2002</u>
Current assets – due from related parties		
Loan due from president (i)	<u>\$ 12,282</u>	<u>\$ 79,390</u>
Due from related parties		
Loan due from officer (ii)	\$ 13,523	-
Note receivable from officer (iii)	202,212	259,770
Due from company controlled by officers (iv)	-	89,541
	<u>\$ 215,735</u>	<u>\$ 349,311</u>

(i) Loan due from president

During 2001, the Company's president who before 2002, had never drawn a salary from the Company, received loan advances of \$70,490 to assist him in his relocation from the United States. This loan is repayable by December 2004 and is secured by shares of the Company owned by the president and a working capital interest in certain oil and gas properties. The value of the security provided to the Company under the terms of the loan agreement at both the end of 2003 and 2002 exceeds the book value of the Loan. The loan accrues interest at the bank prime plus 0.5% per annum and is repayable in equal annual instalments. During the year, \$2,892 (2002 - \$8,900) of interest was accrued on this loan. Subsequent to the year-end, this loan has been paid in full.

(ii) Loan due from officer

This loan is unsecured, non interest bearing, and has no specified terms of repayment. The amount due is for expenses paid by the Company on the officer's behalf. As the amount of the loan is equal to the cost of the expenses; the carrying value approximates the fair value of the loan.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2003 and 2002

7. Due From Related Parties and Related Party Transactions - continued

- (iii) Note receivable from officer
Promissory note bearing interest at 6% per annum and repayable by December 31, 2003. The note is secured by 393,000 common shares of the Company and a personal guarantee from another related officer of the Company. The value of the security provided to the Company at both the end of 2003 and 2002 exceeds the book value of the promissory note. Interest is payable monthly and as a result during the year, \$13,500 (2002 - \$15,070) of interest was accrued on this loan. Subsequent to the year end, the Board approved an amendment to the terms of this promissory note whereby the note is now repayable by December 31, 2007 and bears interest at 3% per annum.

 - (iv) Loan due from company controlled by officers
During the year, the Company purchased oil and gas assets for \$244,000 from this related company (Note 7(b)(iv)). Consideration for this purchase was settled via cash and an offset to this loan and any unpaid interest thereon. The amount due from this company at year-end totalled \$Nil (2002 - \$89,541). Interest of 12% accrued on any unpaid, unsecured advances.
- b) Except as disclosed elsewhere in the financial statements, the Company was involved in the following related party transactions:
- (i) Directors and officers, have charged the Company \$272,000 (2002 - \$239,000) for professional and administrative services.

 - (ii) A law firm in which a director is a partner has charged the Company \$75,000 (2002 - \$13,000) in legal fees. Most of this amount related to the issuance of the flow through shares.

 - (iii) A company owned 100% by a director has charged the Company \$97,000 (2002 - \$Nil) in consulting fees with respect to the research and development of their lateral drainhole drilling technology.

 - (iv) During the year the Company purchased certain oil and gas assets from a company controlled by officers of the Company (Note 7(a)(iv)). As the amount of the exchange is supported by independent evidence, this transaction has been measured at the agreed to exchange amount, being the fair market value of the oil and gas properties. The total purchase price was \$244,000, of which \$89,541 had already been advanced to the company and as such has been excluded from the statement of cash flows.

Transactions in the normal course of operations are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties and which are similar to those negotiable with third parties. Transactions not in the normal course of operations, supported by independent evidence, were recorded at fair market value.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2003 and 2002

8. Equity Instruments

a) Authorized

Unlimited number of common voting shares
Unlimited number of preferred shares, issuable in series.

b) Issued

Common shares

	2003		2002	
	Number of Shares	Amount	Number of Shares	Amount
Balance, beginning of year	6,274,228	\$ 878,104	6,218,228	\$ 861,160
Issued pursuant to private placements (Note 7(f))	1,608,000	415,000	125,000	26,500
Repurchase of common shares	-	-	(69,000)	(9,556)
Flow through shares (Note 7(g))	3,826,076	1,339,126	-	-
Issue costs		(325,805)		-
Tax effect		(357,000)		-
Balance, end of year	11,708,304	\$ 1,949,425	6,274,228	\$ 878,104
Weighted average number of shares outstanding	6,727,306		6,356,228	

c) Repurchase of common shares

During 2003, the Company repurchased nil (2002 – 69,000) of its common shares through a “normal course issuer bid” at an average price of \$nil (2002 - \$0.20) for total cash consideration of \$nil (2002 - \$13,800).

d) Stock options

The Company has established a stock option plan whereby the Company may grant directors, officers, employees and consultants up to a maximum of 10% of the issued common shares. The exercise price of each option equals the market price of the Company's shares on the date of grant. Stock options vest evenly over a 3-year period from the date of grant and expire 5 years after the date of grant.

	2003		2002	
	Number of options	Weighted average exercise price	Number of options	Weighted Average Exercise price
Stock options, beginning of year	620,000	\$ 0.22	502,096	\$ 0.23
Granted	-	-	117,904	0.19
Stock options outstanding, end of year	620,000	\$ 0.22	620,000	\$ 0.23
Exercisable, end of year	541,396	\$ 0.22	541,396	\$ 0.22

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2003 and 2002

8. Equity Instruments – continued

The stock options outstanding as at December 31, 2003 are as follows:

<u>Exercise prices</u>	<u>Options outstanding</u>			<u>Options exercisable</u>	
	<u>Options outstanding</u>	<u>Weighted average remaining term (years)</u>	<u>Weighted average exercise price</u>	<u>Options exercisable</u>	<u>Weighted average exercise price</u>
\$0.19	117,904	4.0	\$ 0.19	39,300	\$ 0.19
\$0.21	302,096	1.0	0.21	302,096	0.21
\$0.25	200,000	1.2	0.25	200,000	0.25
	<u>620,000</u>	<u>1.6</u>	<u>\$ 0.22</u>	<u>541,396</u>	<u>\$ 0.22</u>

The stock options outstanding as at December 31, 2002 are as follows:

<u>Range of exercise prices</u>	<u>Options outstanding</u>			<u>Options exercisable</u>	
	<u>Options outstanding</u>	<u>Weighted average remaining term (years)</u>	<u>Weighted average exercise price</u>	<u>Options exercisable</u>	<u>Weighted average exercise price</u>
\$0.19	117,904	5.0	\$ 0.19	39,300	\$ 0.19
\$0.21	302,096	2.0	0.21	302,096	0.21
\$0.25	200,000	2.2	0.25	200,000	0.25
	<u>620,000</u>	<u>2.6</u>	<u>\$ 0.22</u>	<u>541,396</u>	<u>\$ 0.22</u>

e) Diluted earnings (loss) per share

No diluted earnings (loss) per share figures have been disclosed as such would be anti-dilutive.

f) Private placements

During the year, the Company completed two private placements to arms length parties via the issuance of 500,000 common shares at \$0.25 per share for total consideration of \$125,000 and the issuance of 1,108,000 units at \$0.30 for total consideration of \$332,400. Each unit consisted of one common share and one share purchase warrant (each exercisable into one common share). The total consideration of \$332,400 is estimated to relate to the common shares as to \$290,000 and the warrants as to \$42,400.

The \$42,400 fair value of the 1,108,000 warrants outstanding at December 31, 2003 was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yield (Nil), Expected volatility (0.03), risk-free interest rate (5.0%), and weighted average life of 2 years.

During 2002, the Company completed a private placement to an arms length party via the issuance of \$125,000 common shares at \$0.212 per share for total consideration of \$26,500.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2003 and 2002

8. Equity Instruments – continued

g) Flow through shares

Pursuant to a Prospectus dated November 4, 2003, the Company issued 3,826,076 flow through common shares for gross proceeds of \$1,339,127 (\$0.35 per share). The Company is committed to spend these flow through funds by the end of 2004 on qualifying expenditures.

9. Income Taxes

The effective rate of income tax varies from the statutory rate as follows:

	2003	2002
Combined tax rate	40.74%	39.12%
Expected income tax provision at statutory rate	\$ (137,000)	\$ (91,000)
Non-deductible crown charges	100,000	76,400
Resource allowance	(27,000)	2,800
Non-taxable Alberta royalty tax credits	(10,000)	(19,100)
Other	(3,000)	17,811
Actual income tax provision	\$ (77,000)	\$ (13,089)

Subject to confirmation by income tax authorities, the Company has the following approximate undeducted tax pools:

	2003	2002
Cumulative Canadian Oil and Gas Property Expenses	\$ 250,000	\$ 261,000
Cumulative Canadian Development Expenses	18,000	18,000
Foreign Exploration and Development Expenses	260,000	24,000
Undepreciated Capital Cost	162,000	146,000
Share issue costs	360,000	10,000
Scientific Research and Experimental Development	140,000	107,000
Attributed Canadian Royalty Income	\$ 715,000	\$ 507,000

These pools are deductible from future income at rates prescribed by the Canadian Income Tax Act.

The components of the Company's future income tax asset (liability) are a result of the origination and reversal of temporary differences and are comprised of the following:

Nature of temporary differences	2003	2002
Property and equipment, ARO, License Fee	\$ 24,000	\$ 3,666
Share issue costs	120,000	3,882
Scientific Research and Experimental Development	47,000	26,838
Investment tax credits	71,000	32,182
Attributed Canadian royalty income	82,000	67,416
Unexpended flow-through funds	(490,000)	-
Future income tax (liability) asset	\$ (146,000)	\$ 133,984

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2003 and 2002

10. Commitments

a) Leases

The Company's total obligations, under an automobile lease and an office lease agreement, exclusive of occupancy costs, are as follows:

2004	\$	15,500
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b) Flow through shares

The Company is committed to spend \$1.4 million on qualifying exploration expenditures in 2004, as discussed in Note 8(g).

c) Management consulting agreements

The Chief Executive Officer ("CEO") entered into an Independent Consulting Agreement with the Company dated September 1, 1999 and amended September 1, 2003, to provide services to the Company at a rate of \$50 per hour. Under the terms of the agreement, the CEO is not entitled to invoice the Company for hours in excess of 200 per every four-week period. The agreement terminates on September 1, 2004, unless terminated earlier on 30 days written notice by one party to the other.

The President entered into an Independent Consulting Agreement with the Company dated December 31, 1999 and amended March 1, 2003, to provide services to the Company at a rate of \$110 per hour. Under the terms of agreement, the President is not entitled to invoice the Company for hours in excess of 200 per every four-week period. The agreement terminates on March 1, 2005, unless terminated earlier on 30 days written notice by one party to the other.

11. Contingencies

a) In 2003, the Company settled a lawsuit relating to the ownership rights of certain lateral drainhole drilling technology. The Company accrued the \$70,000 settlement cost in the 2002 financial statements and recorded the license as an asset. The settlement grants the Company a license to manufacture, market and use the technology throughout North America in exchange for the \$70,000 cash settlement and a royalty on future sales.

b) In 2000, the Company commenced legal action against a joint venturer claiming underpayment of a net profit royalty. The joint venturer has issued a counterclaim for an unspecified amount, claiming an overpayment of this royalty. In the opinion of management, the outcome of these claims is not determinable at this time.

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11. Contingencies - continued

- c) In 2003, Alberta Revenue issued Notices of Reassessment to the Company disallowing claims for Alberta Royalty Tax Credits ("ARTC") made in the Alberta Corporate Income tax returns for the years 1998 – 2001. The Company disagrees with these reassessments and the Company has filed a Notice of Objection with Alberta Revenue. No provision has been made in these financial statements for the repayment of these ARTC's, if any, which may be determined to be payable. Should the Company be unsuccessful in defending its position, a liability of approximately \$281,000 of previously received ARTC's, including accrued interest, would arise. In addition, the Company would have to repay \$34,419 of the 2002 ARTC installment claim previously received. These transactions would have a material effect on the Company's financial position. The final outcome of this matter is not determinable at this time.

In view of the above matter, management has not accrued any further ARTC's relating to the oil and gas wells in question. This has resulted in writing off previously recorded ARTC's in the amount of \$50,038. If the Company is successful with its appeal, this amount will be recognized as income in the relevant period.

12. Statement of Cash Flows – Supplemental Information

Interest and income taxes paid

	<u>2003</u>	<u>2002</u>
Interest paid	\$ 17,605	\$ 25,121
Income taxes paid	\$ -	\$ -

13. Financial Instruments

As disclosed in Note 2(g), the Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to interest rate, fair value and industry credit risks. The Company manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

(a) Interest rate risk management

The Company's bank loan is subject to floating rates. The floating rate debt is subject to interest rate cash flow risk, as the required cash flows to service the debt will fluctuate as a result of changes in market rates.

As at December 31, 2003, the increase or decrease in net earnings before taxes for each 1% change in interest rates on floating rate debt amounts to approximately \$nil (2002 - \$4,125) per annum. The related disclosure regarding these debt instruments is included in Note 6 of these financial statements.

December 31, 2003 and 2002

13. Financial Instruments - continued

(b) Fair value risk

The fair value of the related party loan in Note 7(a)(iii) may be different from the carrying value, as this amount is secured by shares of the Company, which as of May 3, 2004 had a trading value of \$106,100. The value of these shares is subject to market price risk as the Company's shares have limited trading activity on the TSX venture exchange. In addition a personal guarantee has been provided by another related officer of the Company for the face value of the loan. As the Company's ability to collect on the guarantee is dependent on the financial position of the officer at the time the loan is called, the value of this guarantee is subject to measurement uncertainty and third party risk.

(c) Credit risk

A significant portion of the Company's trade accounts receivable are from working interest partners in the oil and gas industry and, as such, the Company is exposed to all the risks associated with that industry.

All of the Company's cash is held at one institution and as a result of this and the nature of its operations, the Company has concentrations of credit risk.

14. Major Customers

The Company relies upon its joint interest partner to operate on currently producing properties in which the Company has an interest. 69% (2002 – 75%) of the Company's net petroleum and natural gas sales revenue for the year ended December 31, 2003 and \$49,300 (2002 - \$123,700) in receivables as at December 31, 2003 are generated from properties operated by this joint interest partner. While the Company has concentration of credit risk, it views this credit risk as minimal.

For properties on which the Company operates, the Company also sells its petroleum and natural gas to one purchaser. 27% (2002 – 25%) of the Company's net petroleum and natural gas was sold to this purchaser in 2003. As at December 31, 2003, \$82,000 (2002 - \$54,200) of the Company's receivable is due from this purchaser.

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15. Segmented Information

- (a) The Company's activities include oil and gas production and development of certain lateral drainhole drilling technology. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

<u>Description - 2003</u>	Oil and gas production	Lateral drainhole drilling technology	Total
Petroleum and natural gas sales	\$ 1,324,794	\$ -	\$ 1,324,794
Interest revenue	\$ 15,351	\$ -	\$ 15,351
Depletion, amortization and accretion	\$ 115,511	\$ -	\$ 115,511
Interest expense	\$ 17,605	\$ -	\$ 17,605
Income tax recovery	\$ (77,000)	\$ -	\$ (77,000)
Segment loss	\$ (22,596)	\$ (275,256)	\$ (297,852)
Segment assets	\$ 2,060,879	\$ 65,882	\$ 2,126,761
<u>Description - 2002</u>			
	Oil and gas production	Lateral drainhole drilling technology	Total
Petroleum and natural gas sales	\$ 847,270	\$ -	\$ 847,270
Interest revenue	\$ 42,757	\$ -	\$ 42,757
Depletion, amortization and accretion	\$ 67,185	\$ -	\$ 64,182
Interest expense	\$ 25,121	\$ -	\$ 25,121
Income tax recovery	\$ (13,089)	\$ -	\$ (13,089)
Segment loss	\$ (212,797)	\$ (17,135)	\$ (229,932)
Segment assets	\$ 1,319,840	\$ 70,000	\$ 1,389,840

- (b) The Company's oil and gas production is further split into geographical segments: Canada and the United States of America ("US"). The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

<u>Description - 2003</u>	Canada	US	Total
Petroleum and natural gas sales	\$ 1,268,118	\$ 56,676	\$ 1,324,794
Oil and gas production assets	\$ 1,821,833	\$ 238,988	\$ 2,060,821
<u>Description - 2002</u>			
	Canada	US	Total
Petroleum and natural gas sales	\$ 847,270	\$ -	\$ 847,270
Oil and gas production assets	\$ 1,319,840	\$ -	\$ 1,319,840

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16. Stock Compensation

During 2002, the Company recorded no compensation expense when stock options were issued to employees, as disclosed in Note 2(k).

Had compensation expense related to employees been determined based on the fair value at the grant dates, the net income and earnings per share for the year ended December 31, 2002 would have been reduced to the pro forma amounts indicated below for options issued in 2002:

		2003	2002
Net loss	- as reported	\$ (297,852)	\$ (231,863)
	- pro forma	\$ (301,964)	\$ (234,863)
Loss per share	- basic and diluted		
	- as reported	\$ (0.044)	\$ (0.036)
	- pro forma	\$ (0.045)	\$ (0.037)

The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: Dividend yield (Nil), Expected volatility (0.08), risk-free interest rate (5.0%), and weighted average life of 5 years.

17. Subsequent Events

- (a) In March 2004, the Company entered into a financing agreement with Dominick and Dominick Securities Inc. (the "Agent") to assist the Company raise up to \$2 million consisting of \$1 million of flow through shares at a price of \$0.385 per share and \$1million of common shares at a price of \$0.35 per share. The Company will pay the Agent a commission of 7% of the proceeds and issue the Agent warrants equal to 10% of the number of shares sold. This financing agreement expires on May 31, 2004 and as such, there is no assurance that this financing will be successful.
 - (b) In March 2004, the Company granted 550,000 stock options at a price of \$0.35 per share expiring five years from the date of the option.
 - (c) On May 18, 2004, the \$12,282 due from the president was repaid.
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18. Comparative Figures

Certain of the prior year's figures have been reclassified to conform with current presentation.
