



*Emerald Bay Energy*

**Emerald Bay Energy Inc.**

**Financial Statements**

**For the three months ended**

**March 31, 2010**

**(Prepared by Management – Unaudited)**

**Contents**

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<b>Management Responsibility</b>	<b>2</b>
<b>Financial Statements</b>	
<b>Balance Sheets</b>	<b>3</b>
<b>Statements of Operations and Comprehensive Loss and Deficit</b>	<b>4</b>
<b>Statements of Cash Flows</b>	<b>5</b>
<b>Notes to Financial Statements</b>	<b>6 - 21</b>

## **Notice to the Reader**

The accompanying unaudited interim financial statements of Emerald Bay Energy Inc. for the three months ended March 31, 2010 have been prepared by management and approved by the Board of Directors of the Company. These statements have not been reviewed by the Company's external auditors.

Approved on behalf of Emerald Bay Energy Inc.,

(Signed) "Shelby D. Beattie"  
Director

(Signed) "Gibson C. Scott"  
Director

May 28, 2010  
Calgary, Alberta

# Emerald Bay Energy Inc.

Balance Sheet

As at March 31, 2010 and December 31, 2009

(Unaudited - expressed in Canadian dollars)

	March 31, 2010	December 31, 2009
	\$	\$
<b>Assets</b>		
<b>Current Assets</b>		
Cash	13,791	142,728
Short term investments	50,790	55,864
Accounts and cash call receivable	1,652,299	970,257
Prepaid expenditures	67,869	64,212
Financial contract (note 11c)	102,060	-
	<b>1,886,809</b>	<b>1,233,061</b>
Due from related parties (note 10a)	60,035	63,238
Property, plant and equipment (note 6)	4,990,822	5,053,833
License	9,396	11,835
Investment (note 5)	220,808	-
	<b>7,167,870</b>	<b>6,361,967</b>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Bank loan (note 8)	2,875,000	2,935,019
Accounts payable and accrued liabilities	3,329,634	2,616,909
Current portion of long term debt (note 13)	37,755	13,079
	<b>6,242,389</b>	<b>5,565,007</b>
<b>Long term debt (note 13)</b>	<b>77,936</b>	<b>67,919</b>
<b>Asset retirement obligation (note 7)</b>	<b>134,406</b>	<b>131,757</b>
	<b>6,454,731</b>	<b>5,764,683</b>
<b>Shareholders' equity</b>		
Equity instruments (note 9)	6,172,326	5,932,679
Contributed surplus	766,924	766,924
Deficit	(6,226,111)	(6,102,319)
	<b>713,139</b>	<b>597,284</b>
	<b>7,167,870</b>	<b>6,361,967</b>

Nature of operations (note 1)

Commitments (note 13)

Subsequent events (note 15)

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

# **Emerald Bay Energy Inc.**

## **Statement of Loss, Comprehensive Loss and Deficit For the three months ended March 31, 2010 and 2009**

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(Unaudited - expressed in Canadian dollars)

	<b>March 31, 2010</b>	<b>March 31, 2009</b>
	<b>\$</b>	<b>\$</b>
<b>Revenue</b>		
Petroleum and natural gas sales	<b>397,863</b>	384,376
Royalties	<b>(96,565)</b>	(30,866)
Interest income	-	2,203
	<b>301,298</b>	355,713
<b>Expenses</b>		
Operating	<b>144,313</b>	115,674
General and administrative	<b>357,199</b>	397,581
Depletion, depreciation and accretion (note 6,7 )	<b>150,974</b>	47,593
Unrealized (gain) loss on financial contract (note 11c)	<b>(102,060)</b>	-
Interest	<b>31,935</b>	29,116
Foreign exchange loss	<b>5,229</b>	-
	<b>587,590</b>	589,964
<b>Loss from operations</b>	<b>(286,292)</b>	(234,251)
<b>Future income tax recovery</b>	<b>162,500</b>	336,000
<b>Net (loss) income and comprehensive (loss) income for the period</b>	<b>(123,792)</b>	101,749
<b>Deficit, beginning of period</b>	<b>6,102,319</b>	4,467,892
<b>Deficit, end of period</b>	<b>6,226,111</b>	4,366,143
<b>Basic and diluted income (loss) per share (note 9d )</b>	<b>(0.00)</b>	.01
<b>Weighted average shares outstanding during the period</b>	<b>46,659,446</b>	30,012,753

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

# Emerald Bay Energy Inc.

Statement of Cash Flows

For the three months ended March 31, 2010 and 2009

(Unaudited - expressed in Canadian dollars)

	March 31, 2010	March 31, 2009
	\$	\$
<b>Cash flows provided used in operating activities:</b>		
Net income for the period	(123,792)	101,749
Items not affecting cash:		
Amortization of license fee	2,439	2,574
Depletion, depreciation and accretion	148,535	45,019
Unrealized (gain) loss on financial contract	(102,060)	-
Future income taxes	(162,500)	-
	<u>(237,378)</u>	149,342
Changes in non-cash working capital		
Change in accounts receivable	(682,042)	(337,422)
Change in prepaid expenditures	(3,657)	(152)
Change in accounts payable and accrued liabilities	712,725	191,642
	<u>(210,352)</u>	3,410
<b>Cash flows used in investing activities</b>		
Purchase of property and equipment	(82,875)	(388,384)
Sale of interest in subsidiary	217,111	-
	<u>134,236</u>	(388,384)
<b>Cash flows provided by financing activities</b>		
Payment of related party receivable	3,203	-
Renunciation of flow through benefit	-	(336,000)
Repayment of long term debt	(3,226)	-
Bank demand loan (repayment)	(60,019)	550,000
Share issue costs adjustment	2,147	-
	<u>(57,895)</u>	214,000
<b>Change in cash and cash equivalents</b>	<u>(134,011)</u>	(170,974)
<b>Cash and cash equivalents, beginning of period</b>	<u>198,592</u>	320,290
<b>Cash and cash equivalents, end of period</b>	<u>64,581</u>	149,316
<b>Cash interest paid</b>	31,935	29,116

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

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three months ended March 31, 2010**

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(Unaudited - expressed in Canadian dollars)

## **1 Nature of operations**

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

These financial statements have been prepared in accordance with generally accepted accounting principles applicable to a going concern, which assumes that the Company will be able to meet its obligations and continue its operations for its next fiscal year. Realization values may be substantially different from carrying values as shown and these financial statements do not give effect to adjustments that would be necessary to the carrying values and classification of assets and liabilities should the Company be unable to continue as a going concern.

At March 31, 2010, the Company had not yet achieved profitable operations, had accumulated a deficit of \$6,226,111 since its inception (December 31, 2009 - \$6,102,319) and had a working capital deficiency of \$1,480,580 (December 31, 2009 - \$1,396,927) (excluding the operating loan), and expects to incur further losses in the development of its business, all of which cast significant doubt as to whether the Company is a going concern. The ability to continue as a going concern is dependent on obtaining continued financial support, completing public equity financing, or generating profitable operations in the future. Management is committed to raising additional capital to meet its exploration and operating obligation, however, additional equity financing is subject to the global financial markets and economic conditions, which have recently been disrupted and are volatile, and the debt and equity markets, which have been distressed, particularly for junior petroleum and natural gas companies. These factors, together with the repricing of credit risk, weak natural gas prices and the current unstable economic conditions, have caused, and will likely continue to cause significant doubt as to whether the Company is a going concern.

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three months ended March 31, 2010**

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(Unaudited - expressed in Canadian dollars)

## **2 Significant accounting policies**

These unaudited interim financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"), using the same accounting policies and methods as per the annual audited financial statements for the year ended December 31, 2009. They do not include all of the disclosures required by Canadian GAAP, and should be read in conjunction with the most recent annual audited consolidated financial statements of the Company.

The results of operations for the three months ended March 31, 2010 are not necessarily indicative of those to be expected for the entire year ending December 31, 2010.

## **3 Adoption of accounting standard**

### **Investments**

Investments in companies subject to significant influence are accounted for using the equity method. The equity method is a basis of accounting whereby the investment is initially recorded at cost and the carrying value is adjusted thereafter to include the Company's pro-rata share of post-acquisition income or loss. The amount of the adjustment is included in the determination of net (loss) income by the Company and the investment account of the Company is also increase or decreased to reflect the Company share of capital transactions and changes in accounting policies and corrections of errors. Profit distributions received or receivable from the investments will reduce the carrying value of the investment. Investments accounted for on the equity basis are written down to their fair value when they have a loss in value that is other than a temporary decline.

## **4 Future accounting and reporting changes**

### **International Financial Reporting Standards ("IFRS")**

In 2006, the Canadian Accounting Standards Board ("AcSB") published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian GAAP with IFRS over an expected five year transitional period. In February 2008 the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canada's own GAAP. The date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The transition date of January 1, 2011 will require the restatement

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three months ended March 31, 2010**

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(Unaudited - expressed in Canadian dollars)

for comparative purposes of amounts reported by the Company for the year ended December 31, 2010.

The Company is currently assessing the impact of the conversion from Canadian GAAP to IFRS on its results of operations, financial position, and disclosures and is in the process of developing an IFRS changeover plan. The plan includes an assessment of differences between Canadian GAAP and IFRS, accounting policy choices under IFRS, internal controls over financial reporting, potential system changes required, potential corporate governance changes and effects on internal controls and processes including resources and training required for employees. Initial activities have included training sessions, identification of significant differences between Canadian GAAP and IFRS and acquisition of written standards and examples of IFRS disclosure. The Company will provide disclosures of the key elements of its plan and progress on the project as the information becomes available during the transition period. In addition, the Company has completed a conversion of its accounting system to one which can provide the necessary IFRS inputs. This project was completed over the 3<sup>rd</sup> and 4<sup>th</sup> quarters of 2009 and the 1<sup>st</sup> quarter of 2010. An assessment of necessary modifications to the converted system is the next step and will be completed during the second and third quarters of 2010.

## **Business Combinations, Consolidated Financial Statements and Non-controlling Interest**

In January 2009, the CICA issued CICA Handbook Sections 1582: Business Combinations, Section 1601: Consolidations, and Section 1602: Non-controlling Interest. These sections replace the former CICA Handbook Section 1581: Business Combinations and Section 1600: Consolidated Financial Statements and establish a new section for accounting for a non-controlling interest in a subsidiary. CICA Handbook Section 1582 establishes standards for the accounting for a business combination, and states that all assets and liabilities of an acquired business will be recorded at fair value. Obligations for contingent considerations and contingencies will also be recorded at fair value at the acquisition date. The standard also states that acquisition-related costs will be expensed as incurred and that restructuring charges will be expensed in the periods after the acquisition date. It provides the Canadian equivalent to IFRS 3, Business Combinations (January 2008). The section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011.

CICA Handbook Section 1601 establishes standards for the preparation of consolidated financial statements.

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three months ended March 31, 2010**

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(Unaudited - expressed in Canadian dollars)

CICA Handbook Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in the preparation of consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of IFRS IAS 27, Consolidated and Separate Financial Statements (January 2008).

CICA Handbook Sections 1601 and 1602 apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier adoption of these sections is permitted as of the beginning of a fiscal year.

All three sections must be adopted concurrently. The Company is assessing the impact of these new standards.

## **Equity**

In August 2009, the AcSB issued amendments to CICA Handbook Section 3251: Equity as a result of issuing CICA Handbook Section 1602: Non-controlling Interests. The amendments require non-controlling interests to be recognized as a separate component of equity. The amendments apply only to entities that have adopted Section 1602. The Company is assessing the impact of these new standards.

## **Comprehensive Revaluation of Assets and Liabilities**

In August 2009, the AcSB issued amendments to CICA Handbook Section 1625: Comprehensive Revaluation of Assets and Liabilities for consistency with new CICA Handbook Section 1582: Business Combinations. The amendments apply prospectively to comprehensive revaluations of assets and liabilities occurring in fiscal years beginning on or after January 1, 2011. The Company is assessing the impact of these new standards.

## **Accounting changes**

In June 2009, the AcSB issued an amendment to CICA Handbook Section 1506: Accounting Changes which is effective for fiscal years beginning on or after July 1, 2009. The amendment excludes from the scope of CICA Handbook Section 1506 changes in accounting policies upon the complete replacement of an entity's primary basis of accounting, as will occur when an entity adopts IFRS.

## **5 Acquisition**

On March 4, 2010, the Company announced that it, and a private partner, had acquired 100% of the shares of a private Texas based oil company, Production Resources Inc ("PRI").

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three months ended March 31, 2010

(Unaudited - expressed in Canadian dollars)

Pursuant to the agreement, the Company and the private partner divided the interest, each obtaining 50%. As consideration for the purchase, the Company issued 5,000,000 common shares (\$0.08 CDN per share) and an 18 month consulting agreement valued at \$36,800 USD, for total consideration of \$425,000 USD. The purchase has an effective date of March 1, 2010 and is subject to certain asset and liability adjustments.

On March 15, 2010, the Company sold 50% of its interest in the shares of PRI to Hillcrest Investments Ltd., a private Alberta company, for consideration of \$212,500 US. The sale of these shares is subject to the same asset and liability adjustments as the original purchase. As a result, the Company's ownership interest in PRI decreased to 25%. The Company has accounted for the investment using the equity method.

The investment as at March 31, 2010 is:

	<b>CDN\$</b>
Purchase of 50% interest in PRI	<b>437,919</b>
Sale of 50% interest in PRI to Hillcrest	<b>(217,111)</b>
Net investment	<b><u>220,808</u></b>

## 6 Property and equipment

	<b>March 31, 2010</b>		
	<b>Cost</b>	<b>Accumulated depletion &amp; depreciation</b>	<b>Net book value</b>
	\$	\$	\$
Oil and gas properties	9,673,046	4,782,922	4,890,124
Other	249,049	148,351	100,698
	<b><u>9,922,095</u></b>	<b><u>4,931,273</u></b>	<b><u>4,990,822</u></b>

	<b>December 31, 2009</b>		
	<b>Cost</b>	<b>Accumulated depletion &amp; depreciation</b>	<b>Net book value</b>
	\$	\$	\$
Oil and gas properties	9,591,657	4,651,768	4,939,889
Other	247,564	133,620	113,944
	<b><u>9,839,221</u></b>	<b><u>4,785,388</u></b>	<b><u>5,053,833</u></b>

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three months ended March 31, 2010

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(Unaudited - expressed in Canadian dollars)

The Company applied the ceiling test to its petroleum and natural gas properties at March 31, 2010 and determined that there was no impairment of costs requiring a write down in either of its cost centres.

## 7 Asset Retirement Obligation

The Company is legally required to restore its properties to their original condition. Estimated future site restoration costs are based upon engineering estimates of the anticipated method and the extent of site restoration required in accordance with current legislation and industry practices in the various jurisdictions in which the Company has properties.

As at March 31, 2010, the Company estimated the total undiscounted amount of cash flows required to settle its ARO to be \$312,558 (December 31, 2009 - \$312,558), which are estimated to be incurred over the next 15 years. The Company calculated ARO using a credit adjusted risk free interest rate of 7.5% and an inflation rate of 2%, which resulted in the recording of ARO of \$134,406 (December 31, 2009 - \$131,757).

	<b>March 31, 2010</b>
	<b>\$</b>
Balance, beginning of period	<b>131,757</b>
Accretion	<b>2,649</b>
Balance, end of period	<b>134,406</b>

## 8 Bank Loan

The Company has a \$3,000,000 (December 31, 2009 - \$3,250,000) revolving operating demand loan, of which \$2,875,000 (December 31, 2009 - \$2,935,019), has been drawn at March 31, 2010. Interest is calculated at the bank's prime rate plus 1.50%.

Security for the loan consists of a \$10,000,000 Debenture with a floating charge over all assets of the Company with a Negative Pledge and Undertaking to provide fixed charges on the Borrower's major producing petroleum properties at the request of the bank. The Company is required to maintain certain covenants, which the Company is in violation of as at March 31, 2010. The bank has not made demand of the Corporation's credit facilities but retains the right to do so.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three months ended March 31, 2010

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(Unaudited - expressed in Canadian dollars)

## 9 Share Capital

### a) Authorized

Unlimited number of common shares with voting rights.

Unlimited number of preferred shares, issuable in series.

### b) Issued

	Number of Common Shares	Amount \$
Outstanding, December 31, 2009	45,159,446	5,830,596
Tax effect of flow-through shares(ii)	-	(162,500)
Shares issued on purchase of non-controlled subsidiary(i)	5,000,000	400,000
Share issue costs	-	2,147
<b>Outstanding, March 31, 2010</b>	<b>50,159,446</b>	<b>6,070,243</b>
Warrants outstanding, beginning and end of period	9,625,000	102,083
Equity instruments balance at March 31, 2010		<b>6,172,326</b>

(i) On March 4, 2010, the Company issued 5,000,000 common shares with a value of \$400,000 (\$.08/share). These shares were issued as consideration for the purchase of 50% of the share of a private Texas based oil and gas company.

(ii) The Company committed to incur \$650,000 on qualifying exploration and development expenditures prior to December 31, 2010 relating to flow-through share agreements issued in 2009. The Company has renounced these expenditures as at December 31, 2009 and filed the necessary documents with the Canada Revenue Agency in 2010. Accordingly, the future income tax of \$162,500 has been recorded in the period. As at March 31, 2010, the total of \$650,000 remains to be incurred.

### c) Stock options outstanding

The Company established a share option plan (the "Plan") during 2008 for the benefit of officers, directors, employees and consultants of the Company. Under the Plan, the number of common shares to be reserved and authorized for issuance pursuant to options granted under the Plan cannot exceed 10% of the total number of issued and outstanding shares of

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three months ended March 31, 2010

(Unaudited - expressed in Canadian dollars)

the Company. The exercise price of each option equals the market price of the Company's shares on the date of grant. All currently issued options have terms of five years. Stock options granted during 2009 and 2008 all vested immediately on issuance.

During the period ended March 31, 2010, there were no stock options granted or exercised, and 617,117 options issued to agents expired. The following table summarizes information about the Company's stock options outstanding and exercisable at March 31, 2010:

	March 31, 2010		December 31, 2009	
	Number of options	Weighted Average Exercise price	Number of options	Weighted Average Exercise price
<b>Employee, Directors, Consultants</b>				
Stock options, beginning of period	1,850,000	\$0.24	2,275,000	\$ 0.26
Granted	-	-	-	-
Expired	-	-	(425,000)	0.32
Stock options outstanding, end of period	1,850,000	0.24	1,850,000	\$ 0.24

	March 31, 2010		December 31, 2009	
	Number of options	Weighted Average Exercise price (\$)	Number of options	Weighted Average Exercise price
<b>Agents</b>				
Agent options, beginning of period	1,090,617	\$0.12	613,117	\$ 0.15
Agent options granted	-	-	477,500	0.08
Agent options expired	(613,117)	0.15	-	-
Agent options outstanding, end of period	477,500	0.08	1,090,617	\$ 0.12

The total stock options outstanding at March 31, 2010 are as follows:

Exercise prices	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price
\$0.08	477,500	0.6	\$0.08
\$0.17	200,000	2.5	0.17
\$0.25	1,650,000	0.6	0.25
	2,327,500	0.8	\$0.21

As at March 31, 2010 all outstanding options have vested and are exercisable.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three months ended March 31, 2010

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(Unaudited - expressed in Canadian dollars)

## d) Diluted (loss) earnings per share

Basic earnings per share are calculated based on the weighted average number of shares outstanding during the period of 46,659,446. The treasury stock method is used for the calculation of diluted loss per share. Under this method, it is assumed that proceeds from the exercise of dilutive securities are used by the Company to repurchase Company shares at the average price during the period. During the period, the Company did not have any dilutive securities outstanding.

## 10 Related Parties

a) The following amounts are due by related parties:

	March 31, 2010	December 31, 2009
	\$	\$
Note receivable from officer (i)	220,116	218,500
Fair value allowance	(206,710)	(206,710)
Net note receivable	13,406	11,790
Advance fees (ii)	46,629	51,448
	60,035	63,238

- (i) Promissory note bearing interest at 3% per annum and repayable by December 31, 2012 unless the officer's employment is terminated or he is petitioned into bankruptcy wherein the note and accrued interest becomes immediately payable. The note is secured by 393,000 common shares of the Company which had a fair value of \$25,545 at March 31, 2010 (December 31, 2009 - \$35,370).
- (ii) The fair value allowance was determined in 2008, based on the market value at December 31, 2008 of the secured shares. The Company has not provided an allowance to the estimated fair value of the 393,000 common shares held as security as the fair value at March 31, 2010 and December 31, 2009 exceeded the carrying amount.
- (iii) A director was advanced fees in relation to efforts to finance and advance the Company's drilling technology. At March 31, 2010 \$46,629 (December 31, 2009 - \$51,448) remains outstanding. There is no guarantee that such efforts will be successful and if such efforts are not successful, the full balance will be repaid by December 31, 2010.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three months ended March 31, 2010

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(Unaudited - expressed in Canadian dollars)

- b) Except as disclosed elsewhere in the financial statements, the Company was involved in the following related party transactions for the period ended March 31, 2010:
  - (i) Directors and officers, have charged the Company \$70,773 (2009 - \$103,410) for management services related to managing the day to day operations of the Company in Canada and the United States, inclusive of filling the role of Company President.
  - (ii) A law firm in which a director is a partner has charged the Company \$7,854 (2009 - \$5,814) in legal fees for normal corporate matters.
  - (iii) A US corporation, owned and controlled by an officer and a director has charged the Company \$10,800 (2009 - \$Nil) for costs it incurred for operation of the Company's US properties.

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.

## 11 Financial Instruments and Risk Management

### a) Fair values

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, and accounts payable and accrued liabilities. The fair values of these financial instruments approximate their carrying value due to their short-term nature.

Effective December 31, 2009, the Company adopted the amendments to CICA Section 3862 "Financial Instruments – Disclosures". These amendments require the Company to present information about financial instruments measured at fair value in accordance with a three level hierarchy. The hierarchy groups financial assets and liabilities into three levels based on the significance of inputs used in measuring the fair values of the financial assets and liabilities. The fair value hierarchy has the following levels:

- (i) Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities;
- (ii) Level 2: inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- (iii) Level 3: inputs for the asset or liability that are not based on observable market data (unobservable inputs).

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three months ended March 31, 2010**

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(Unaudited - expressed in Canadian dollars)

The level within which the financial asset or liability is classified is determined based on the lowest level of significant input to the fair value measurement. At March 31, 2010, the Company's cash and cash equivalents and its investment in PRI were subject to valuation. Cash and cash equivalents have been valued through level 1. The fair value of the investment is determined by the best available information including regard for market conditions and other factors that a market participant would consider for such investments, which is the consideration given for the investment.

## **b) Credit risk**

The majority of the Company's accounts receivable are due from joint venture partners in the oil and gas industry and from purchasers of the Company's petroleum and natural gas production and are subject to the same industry factors such as commodity price fluctuations and escalating costs. The Company generally extends unsecured credit to these customers and therefore, the collection of accounts receivable may be affected by changes in economic or other conditions. Management believes risk is mitigated by the size and reputation of the companies to which they extend credit. The Company has not experienced any credit loss in the collection of accounts receivable in the period ended March 31, 2010.

Receivables from petroleum and natural gas marketers are normally collected on the twenty-fifth day of the month following production. Receivables related to the sale of the Company's oil and natural gas production are from major marketing companies. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers.

Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to expenditure and issuing cash calls on large capital projects before they commence.

## **c) Market risk**

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices and interest rates will affect the Company's net earnings or the value of financial instruments. These risks are generally outside the control of the Company. At present, the Company produces primarily natural gas. A \$.50/mcf increase or decrease in the price received for natural gas would result in approximately a \$14,000 increase or decrease in the monthly Petroleum and Natural Gas sales.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three months ended March 31, 2010

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(Unaudited - expressed in Canadian dollars)

In the past the Company has sold all of its gas on the spot market which historically has outperformed many corporations' active hedging programs. However, in order to reduce risk in 2010, in September 2009 the Company entered into a financial instrument, for the period January 1, 2010 to December 31, 2010, which collared the received price of natural gas between \$4.53/GJ and \$7.53/GJ for 500 GJ/day.

The fair value of the contract at March 31, 2010 was \$102,060 and this valuation resulted in an unrealized gain on the contract of \$102,060.

The Company is exposed to Interest rate risk on its bank loan which has an interest rate of prime plus 1.5%. An estimated one percent change in the interest rate either way for the year would have affected the Company's statement of operations by \$6,800 for the three months ended March 31, 2010.

## d) **Currency risk**

The Company is exposed to the financial risk related to the fluctuation of foreign exchange rates. The Company operates in Canada and the United States and a portion of its expenses are incurred in US dollars. The Company does not hedge its exposure to fluctuations in the exchange rate. Future changes in exchange rates could have a material effect on the Company's business including its intended capital plans, its financial condition and results of operations.

Certain of the Company's financial instruments are exposed to fluctuations in the US dollar, including cash and cash equivalents, accounts receivable and accounts payable and accrued liabilities. A hypothetical change of 10% to the foreign exchange rate between the US dollar and the Canadian dollar applied to the average level of US denominated cash and cash equivalents during the three months ended March 31, 2010 would have had approximately a \$6,900 impact on the Company's earnings for the quarter.

## e) **Liquidity risk**

Liquidity difficulties would emerge if the Company were unable to meet its financial obligations as they fell due within normal credit terms. This may be the consequence of diminished cash flows resulting from lower product prices, production interruptions, or unexpected operating or capital cost increases. Liquidity difficulties could also occur if the Company's bankers were unable to continue to provide credit (when and if applicable) at a level and on terms compatible with the Company's

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three months ended March 31, 2010

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(Unaudited - expressed in Canadian dollars)

capital requirements. Generally, the Company will, over a reasonable period of time, limit its capital programs to funds flow from operations, available cash and available credit. In addition, the Company endeavors to maintain its debt at a level that will ensure financial flexibility to deal with unforeseen or rapidly changing circumstances.

The Company's net current liabilities and other liabilities and the manner in which they are expected to be met are as follows:

Net working capital deficiency	\$1,480,580	This amount is anticipated to be met out of additional share issuance in the 2010 fiscal period.
Bank debt (Note 7)	\$2,875,000	The Company anticipates issuing additional share capital to reduce this amount in 2010. This amount is secured by the Company's oil and gas assets which have value sufficient such that the Company has no reason to believe that the bank will require repayment within the next fiscal period.
Long term debt	\$77,936	Vehicle leases will be paid over 5 years and the consulting contract will be paid over 6 months out of normal cash flow.

## 12 Capital management

The Company's capital consists of shareholders' equity, bank debt and working capital. The Company will adjust its capital structure to manage its current and future debt, drilling programs and potential corporate acquisitions through the issuance of shares, increasing the credit facility line and adjustments to capital spending.

The Company's objective for managing capital is to maximize long-term Shareholder value by ensuring adequate capital to achieve the Company's objectives.

The Company monitors capital structure using non-GAAP measures, based on the ratio of net debt to annualized funds flow. The Company also monitors capital structure by reviewing net asset value.

The Company is bound by certain debt covenants. These covenants include maintaining a Working Capital Ratio of not less than 1.0 to 1.0 at all times. The Working Capital ratio for this purpose is defined as Current Assets (including the un-drawn availability under the Credit Facility A) to Current Liabilities (excluding any current portion of Bank Debt). As at March 31, 2010, the Company was in violation of this bank covenant.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three months ended March 31, 2010

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(Unaudited - expressed in Canadian dollars)

In order to resolve its working capital ratio and to access additional share equity the Company will be emphasizing development of its U.S. properties. The Company has received preliminary expressions of interest from third parties, interested in investing substantial sums in the Company if it focuses on its US properties.

## 13 Commitments

- a) Under a lease agreement for five (5) years commencing April 1, 2009 and ending March 31, 2014, the Company has committed to payments of \$5,420 per month under a rental agreement for office space.
- b) The Company has entered into various vehicle lease agreements with estimated minimum annual payments of \$17,359 per year through 2015. Total annual principle repayments for fiscal years 2010 through to 2015 are respectively as follows: \$13,079, \$13,553, \$13,776, \$14,554, \$15,082 and \$10,954.
- c) As partial consideration for the non-controlling acquisition of the shares of a Texas oil and gas company, the Company has entered into a consulting contract aggregating \$37,919 (USD -\$36,800). The contract commences March 1, 2010 and has a term of 18 months. The current portion of this long term debt is \$24,730 and the long term portion is \$13,189.

## 14 Segmented information

The Company's oil and gas production is split between 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.

	<b>March 31, 2010 (\$)</b>		
	<b>Canada</b>	<b>United States</b>	<b>Total</b>
Petroleum and natural gas sales	377,577	20,286	397,863
Oil and gas production assets	4,669,599	321,223	4,990,822
License	9,396	-	9,396

  

	<b>December 31, 2009 (\$)</b>		
	<b>Canada</b>	<b>United States</b>	<b>Total</b>
Petroleum and natural gas sales	1,386,197	101,598	1,487,795
Oil and gas production assets	4,724,809	329,024	5,053,833
License	11,835	-	11,835

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three months ended March 31, 2010**

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(Unaudited - expressed in Canadian dollars)

## **15 Subsequent events**

Subsequent to March 31, 2010, the Company entered into the following transactions:

On April 6, 2010, the Company announced that it had granted incentive share options aggregating 3,150,000 common shares of the Company at a price of \$0.10 per share for a period of five years under the formal stock option plan approved at the Annual General Meeting held on December 22, 2009, subject to regulatory approval, to directors, officer, employees and consultants of the Company.