

**Emerald Bay Energy Inc.**  
**Financial Statements**  
For the year ended December 31, 2002

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**Contents**

<b>Auditors' Report</b>	<b>2</b>
<b>Financial Statements</b>	
<b>Balance Sheets</b>	<b>3</b>
<b>Statements of Operations and Deficit</b>	<b>4</b>
<b>Statements of Cash Flows</b>	<b>5</b>
<b>Notes to Financial Statements</b>	<b>6 - 19</b>



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## Auditors' Report

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### **To the Shareholders Emerald Bay Energy Inc.**

We have audited the balance sheet of Emerald Bay Energy Inc. as at December 31, 2002 and the statements of operations and deficit and cash flows for the year 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 audit.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2002 and the results of its operations and its cash flows for the year then ended, in accordance with Canadian generally accepted accounting principles.

The comparative figures included herein for the year ended December 31, 2001 were reported on by another firm of Chartered Accountants who issued their report without reservation on July 26, 2002.

*“signed BDO Dunwoody LLP”*

### **Chartered Accountants**

Calgary, Alberta  
April 14, 2003  
(except for Note 16(a), (c) and (d) which are as of May 14, 2003)

**Emerald Bay Energy Inc.  
Balance Sheets**

**As at December 31**

**2002**

**2001**

**Assets**

**Current**

Cash and short term investments	\$ 37,089	\$ 131,797
Accounts receivable (Note 14)	257,901	114,760
Prepaid expenses and deposits	15,580	19,427
Due from related parties (Note 6)	<u>339,160</u>	<u>23,497</u>
	<b>649,730</b>	289,481

<b>Due from related parties (Note 6)</b>	<b>89,541</b>	350,912
<b>Property, plant and equipment (Note 4)</b>	<b>434,801</b>	393,457
<b>License fee (Note 10(a))</b>	<b>70,000</b>	-
<b>Future income taxes (Note 8)</b>	<u><b>134,928</b></u>	<u>121,839</u>
	<b>\$ 1,379,000</b>	<b>\$ 1,155,689</b>

**Liabilities and Shareholders' Equity**

**Current**

Bank loan (Note 5)	\$ 412,500	\$ 225,000
Accounts payable and accrued liabilities (Note 10(a))	<u>386,906</u>	<u>136,200</u>
	<b>799,406</b>	361,200

<b>Abandonment and site restoration provision</b>	<u><b>11,881</b></u>	<u>7,613</u>
	<b>811,287</b>	368,813

**Shareholders' equity**

Share capital (Note 7)	<b>878,104</b>	861,160
Deficit	<u><b>(310,391)</b></u>	<u>(74,284)</u>
	<b>567,713</b>	786,876
	<b>\$ 1,379,000</b>	<b>\$ 1,155,689</b>

"signed Shelby D. Beattie" Director  
Shelby D. Beattie

"signed Richard D. Tingle Q.C." Director  
Richard D. Tingle Q.C.

**Emerald Bay Energy Inc.**  
**Statements of Operations and Deficit**

<b>For the years ended December 31</b>	<b>2002</b>	<b>2001</b>
<b>Revenue</b>		
Petroleum and natural gas sales	\$ 847,270	\$ 945,802
Royalties	(224,575)	(233,910)
Alberta Royalty Tax Credits	48,819	58,952
Gain (loss) on futures contracts	(52,664)	14,161
	<u>618,850</u>	<u>785,005</u>
<b>Expenses</b>		
Operating	189,265	207,442
General and administrative	634,583	407,963
Research and development	17,135	61,739
Depletion, amortization and site restoration	70,478	82,311
Interest	25,121	6,815
	<u>936,582</u>	<u>766,270</u>
<b>Income (loss) from operations</b>	<u>(312,732)</u>	<u>18,735</u>
<b>Other income</b>		
Alberta royalty tax credits for prior years (Note 3)	-	211,745
Gain on sale of property and equipment	25,023	15,737
Interest	42,757	18,864
	<u>67,780</u>	<u>246,346</u>
<b>Income (loss) before income taxes</b>	<u>(244,952)</u>	<u>265,081</u>
<b>Income taxes (Note 8)</b>		
Current	-	4,000
Future	(13,089)	(57,761)
	<u>(13,089)</u>	<u>(23,761)</u>
<b>Net income (loss) for the year</b>	<u>(231,863)</u>	<u>288,842</u>
Deficit, beginning of year	(74,284)	(363,126)
Purchase price of common shares repurchased in excess of book value (Note 7(c))	(4,244)	-
<b>Deficit, end of year</b>	<u>\$ (310,391)</u>	<u>\$ (74,284)</u>
<b>Earnings (loss) per common share (Note 7(e))</b>		
	<u>\$ (0.036)</u>	<u>\$ 0.045</u>
<b>Weighted average number of shares</b>		
	<u>6,356,228</u>	<u>6,335,000</u>

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**

**2002**

**2001**

**Cash flows from operating activities**

Net income (loss) for the year	\$ (231,863)	\$ 288,842
Adjustments for:		
Depletion, amortization and site restoration	70,478	82,311
Future income taxes	(13,089)	(57,761)
Gain on sale of property and equipment	(25,023)	(15,737)
<b>Cash flow from operations</b>	<b>(199,497)</b>	<b>297,655</b>
Changes in non-cash operating balances		
Accounts receivable	(143,141)	138,044
Prepaid expenses and deposits	3,848	779
Accounts payable and accrued liabilities	180,706	(77,099)
Income taxes	-	(27,000)
	<u>(158,084)</u>	<u>332,379</u>

**Cash flows from investing activities**

Note receivable	(15,070)	(13,100)
Purchases of property, plant and equipment	(120,032)	(121,486)
Proceeds on disposition of property, plant and equipment	37,500	31,256
	<u>(97,602)</u>	<u>(103,330)</u>

**Cash flows from financing activities**

Bank loan	187,500	110,000
Advances to related parties	(39,222)	(188,461)
Issuance (repurchase) of share capital, net	12,700	(31,800)
	<u>160,978</u>	<u>(110,261)</u>

**Increase (decrease) in cash and short term investments**

	(94,708)	118,788
Cash and short term investments, beginning of year	<u>131,797</u>	<u>13,009</u>
<b>Cash and short term investments, end of year</b>	<b>\$ 37,089</b>	<b>\$ 131,797</b>

<b>Cash flow from (used in) operations per share</b>	<b>\$ (0.031)</b>	<b>\$ 0.047</b>
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See Note 12 for supplemental cash flow information

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**Emerald Bay Energy Inc.**  
**Notes To Financial Statements**

**December 31, 2002 and 2001**

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**1. Nature of Operations**

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Emerald Bay Energy Inc. (the "Company") was incorporated under the Business Corporations Act of Alberta on May 9, 1991. 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. At December 31, 2002, the Company had incurred a significant loss for the year, partly due to the costs of successfully resolving the lateral drainhole lawsuit (Note 10(a) and partly due to professional fees incurred in connection with the reissuance of the 2000 and 1999 financial statements (Note 16).

The Company's ability to continue as a going concern is dependent upon the Company achieving profitable results and the continuing support its Company's bankers. Future lateral drainhole drilling operations are dependent on an injection of capital and or an appropriate level of financing. Management are confident that the Company will achieve profitable oil & gas operations in 2003 and have the required financial resources to do so.

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**2. Summary of Significant Accounting Policies**

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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) Inventories and revenue

Revenue is recognized on production sold and is net of transportation costs. Inventories of petroleum products, operating supplies and raw materials are valued at the lower of cost and net realizable value.

(b) Property, plant 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.

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**December 31, 2002 and 2001**

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**2. Summary of Significant Accounting Policies - continued**

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(b) Property, plant 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. Alberta Royalty Tax Credits are included in oil and gas sales.

In applying the full cost method, the Company performs a ceiling test which restricts the capitalized costs less accumulated depletion and amortization from exceeding an amount equal to the estimated undiscounted value of future net revenues from proved oil and gas reserves, as determined by independent engineers, based on sales prices achievable under existing contracts and posted average reference prices in effect at the end of the year and current costs, and after deducting estimated future general and administrative expenses, production related expenses, financing costs, future site restoration costs and income taxes.

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) Environmental and site restoration costs

A provision for environmental and site restoration costs is made when restoration requirements are established and costs can be reasonably estimated. The balance of future salvage value of assets is netted against the future site restoration accrual. The site restoration costs are accrued on the basis of actual production. The accrual is based on management's best estimate of these future costs on the ratio of actual production to proved producing reserves.

(e) 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. The Company provides for the future effect on income taxes related to flow-through shares as a charge to share capital when the expenditures are incurred. No liability regarding future taxes is recorded on unexpended flow-through share capital.

(f) 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.

**December 31, 2002 and 2001**

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**2. Summary of Significant Accounting Policies – continued**

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(g) Measurement uncertainty

The amounts recorded for depletion and amortization of petroleum and natural gas properties and equipment and the provision for future site restoration and reclamation 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.

(h) 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.

(i) Stock based compensation plan

Effective January 1, 2002, the Company adopted the recommendations of CICA Handbook Section 3870, Stock Based Compensation and Other Stock-Based Payments. This section requires that direct awards of stock and liabilities based on the price of common stock be measured at fair value at each reporting date, with the change in fair value reported in the statements of income and encourages, but does not require, the use of the fair value method for all other types of stock-based compensation plans. None of the Company's plans qualify as direct awards of stock or as plans that create liabilities based on the price of the company's stock, and as a result, the implementation of the section has no impact on the financial statements. The Company has chosen not to use the fair value method to account for stock-based employee compensation plans, but to disclose pro-forma information for options granted after January 1, 2002. The Company records no compensation expense when options are issued to employees. Any consideration paid by employees on the exercise of the options is credited to capital stock.

(j) Per share amounts

Basic earnings (loss) per common share and cash flow from operations per common share are computed by dividing earnings (loss) and cash flow from operations 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.

(k) Cash and short-term investments

Cash and short-term investments include bank balances and deposits for purposes of purchasing futures contracts in 2001.

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**Emerald Bay Energy Inc.**  
**Notes To Financial Statements**

**December 31, 2002 and 2001**

**2. Summary of Significant Accounting Policies – continued**

(l) License fee

License fee relates to patent rights of certain lateral drainhole drilling technology (Note 10(a)). Commencing in 2003 this license fee will be amortized over the remaining life of the patent (17 years).

(m) 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. During 2002, \$nil (2001 - \$25,067) have been accrued and therefore reduced research and development expense.

**3. Alberta Royalty Tax Credits**

During the year ended December 31, 2001, the Company received \$224,405 of Alberta Royalty Tax Credit ("ARTC") payments which relate to royalties paid in 1998, 1999, and 2000. These ARTC's related to certain properties which management previously believed did not qualify for these tax credits. The Company amended and re-filed its tax returns for 1998 and 1999 and claimed ARTC on its 2000 income tax return. However no credit was recognized in the Company's December 31, 2000 financial statements until the returns were assessed and audited by the taxation authorities and recovery was assured. The amount reported in the 2001 financial statements has been reduced by \$12,660 being the effect of the prior years' errors (Note 16).

**4. Property, Plant and Equipment**

	2002			2001		
	Cost	Accumulated Depletion and Amortization	Net Book Value	Cost	Accumulated Depletion and Amortization	Net Book Value
Petroleum and natural gas properties	\$ 905,924	\$ 492,204	\$ 413,720	\$ 788,175	\$ 432,226	\$ 355,949
Furniture and equipment	50,077	28,996	21,081	60,272	22,764	37,508
	<u>\$ 956,001</u>	<u>\$ 521,200</u>	<u>\$ 434,801</u>	<u>\$ 848,447</u>	<u>\$ 454,990</u>	<u>\$ 393,457</u>

At December 31, 2002, the Company applied a ceiling test to its oil and gas assets using a gas price of \$6.04 (2001 - \$3.26) per mcf on gas and an oil price of \$47.59 (2001 - \$27.70) per barrel. The application of this test resulted in an excess ceiling value over the net book value.

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**Emerald Bay Energy Inc.**  
**Notes To Financial Statements**

**December 31, 2002 and 2001**

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**4. Property, plant and equipment - continued**

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At December 31, 2002, total future site restoration and abandonment costs are estimated to be \$41,200 (2001 - \$15,000) before salvage value of the equipment.

The Company did not capitalize any general and administrative costs during 2002 and 2001.

No unproved property costs have been deducted from costs subject to depletion and amortization in 2002 and 2001.

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**5. Bank Loan**

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The Company has a \$525,000 (2001 - \$525,000) revolving production loan facility, of which \$412,500 (2001 - \$225,000) plus accrued interest, has been drawn at December 31, 2002. Interest is calculated at the bank's prime rate plus 1.5% (2001 - 1.5%). The authorized limit of this loan facility is to be reduced by \$15,000 per month commencing January 30, 2003 and re-assessed at the next review in May 2003.

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.

The Company is in default with certain bank loan covenants established by the bank in January 2003 and this is mainly due to approximately \$125,000 of a one-time costs incurrent in 2002 relating to professional fees paid to both settle the lawsuit (Note 10(a)) and in connection with the re-issuance of the 1999 and 2000 financial statements (Note 16) and certain other administrative costs relating to the prior year.

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**6. Related Party Transactions**

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The following amounts are due by related parties:

	<u>2002</u>	<u>2001</u>
<b>Current assets – due from related parties</b>		
Current portion of loan due by president (a)	\$ 79,390	\$ 23,497
Note receivable from officer (b)	259,770	-
	<u>\$ 339,160</u>	<u>\$ 23,497</u>
 <b>Due from related parties</b>		
Note receivable from officer (b)	\$ -	\$ 244,700
Loan due by president (a)	-	46,993
Due from company controlled by officers (c)	89,541	59,219
	<u>\$ 89,541</u>	<u>\$ 350,912</u>

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**Emerald Bay Energy Inc.**  
**Notes To Financial Statements**

**December 31, 2002 and 2001**

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**6. Related Party Transactions – continued**

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(a) Loan due by 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 is approximately \$140,000 (2001 - \$161,000). The loan accrues interest at the bank prime plus 0.5% per annum and is repayable in equal annual instalments commencing December 31, 2002. During 2002, \$8,900 of interest has been accrued on this loan. As disclosed in Note 17(c), subsequent to the year-end, the president made a \$70,000 loan repayment.

(b) Note receivable from officer

Promissory note bearing interest of 6% per annum, repayable by December 31, 2003 and secured by 393,000 common shares of the Company and a personal guarantee from another related officer of the Company. Interest is payable monthly, commencing January 25, 2002. The value of the security provided by the Company at both the end of 2002 and 2001 exceeds the book value of the Note. As disclosed in Note 17(d), subsequent to the year-end, the officer paid all outstanding interest payments and a \$30,000 principle loan payment. During 2002, \$15,070 of interest has been accrued on this loan.

(c) Loan due by company controlled by officers

During the year, the Company made net advances of \$20,000 and paid expenses on behalf of this company totalling \$10,321. The amount due by this company at year-end totalled \$89,541 (2001 – \$59,219). Interest of 12% accrues on these unpaid, unsecured advances. As per Note 17(a), subsequent to the year-end, the Company purchased oil and gas assets from this related company. Consideration for this purchase will be settled via cash and an offset to this loan and any unpaid interest thereon.

(d) Directors and officers have charged the Company \$174,000 (2001 - \$158,000) for professional and administrative services.

With the exception of advances to related parties, the above transactions are in the normal course of operations and are measured at the exchange amount, the amount of consideration established and agreed to by the related parties.

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**Emerald Bay Energy Inc.**  
**Notes To Financial Statements**

**December 31, 2002 and 2001**

**7. Share Capital**

(a) Authorized

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

(b) Issued

Common shares

	<b>2002</b>		2001	
	<b>Number of Shares</b>	<b>Amount</b>	Number of Shares	Amount
<b>Balance, beginning of year</b>	<b>6,218,228</b>	<b>\$ 861,160</b>	6,356,228	\$ 892,960
To be issued pursuant to private placement (Note 7(f))	<b>125,000</b>	<b>26,500</b>	-	-
Repurchase of common shares to be cancelled (Note 7(c))	<b>(69,000)</b>	<b>(9,556)</b>	(138,000)	(31,800)
<b>Balance, end of year</b>	<b>6,274,228</b>	<b>\$ 878,104</b>	6,218,228	\$ 861,160
<b>Weighted average number of shares outstanding</b>	<b>6,356,228</b>		6,335,000	

(c) During 2002, the Company repurchased 69,000 (2001 - 138,000) of its common shares at an average price of \$0.20 (2001 - \$0.23) for total cash consideration of \$13,800 (2001 - \$31,801). This resulted in a \$9,556 charge to share capital and a \$4,244 charge to deficit. These shares remain un-cancelled at December 31, 2002.

(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 the 3-year period from the date of grant and expire 5 years after the date of grant.

**Emerald Bay Energy Inc.  
Notes To Financial Statements**

**December 31, 2002 and 2001**

**7. Share Capital - continued**

	2002		2001	
	Number of options	Weighted average exercise price	Number of options	Weighted Average Exercise price
Stock options, beginning of year	502,096	\$ 0.23	502,096	\$ 0.23
Granted	117,904	0.19	-	-
Stock options outstanding, end of year	620,000	\$ 0.22	502,096	\$ 0.23
Exercisable, end of year	541,396	\$ 0.22	435,428	\$ 0.22

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

Exercise prices	Options outstanding		Options exercisable		
	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
\$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
	620,000	2.6	\$ 0.22	541,396	\$ 0.22

The stock options outstanding as at December 31, 2001 are as follows:

Range of exercise prices	Options outstanding		Options exercisable		
	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
\$0.21	302,096	3.0	0.21	302,096	0.21
\$0.25	200,000	3.2	0.25	133,332	0.25
	502,096	3.1	\$ 0.23	435,428	\$ 0.22

(e) Diluted earnings (loss) per share

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

(f) Private placement

During the year, 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, 2002 and 2001**

**8. Income Taxes**

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

	<u>2002</u>	<u>2001</u>
Combined tax rate	<b>39.12%</b>	42.6%
Expected income tax provision at statutory rate	\$ (91,000)	\$ 113,000
Non-deductible crown charges	76,400	100,200
Resource loss (allowance)	2,800	(24,600)
Change in valuation allowance	-	(64,077)
Non-taxable Alberta royalty tax credits	(19,100)	(115,100)
Non-taxable investment tax credits and other	17,811	(33,184)
Actual income tax provision	<u>\$ (13,089)</u>	<u>\$ (23,761)</u>

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

	<u>2002</u>	<u>2001</u>
Cumulative Canadian Oil and Gas Property Expenses	\$ 261,000	\$ 255,000
Cumulative Canadian Development Expenses	\$ 18,000	\$ 500
Foreign Exploration and Development Expenses	\$ 24,000	\$ 26,000
Undepreciated Capital cost	\$ 146,000	\$ 139,000
Non-capital losses carried forward for tax purposes available from time to time until 2006	\$ 68,000	\$ -
Share issue costs	\$ 10,000	\$ 23,000
Net capital losses carried forward	\$ 28,000	\$ -

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 liabilities are a result of the origination and reversal of temporary differences and are comprised of the following:

<b>Nature of temporary differences</b>	<u>2002</u>	<u>2001</u>
Property, plant and equipment	\$ 4,610	\$ 70,288
Share issue costs	3,882	4,840
Non-capital losses	26,838	-
Investment tax credits	32,182	-
Attributed Canadian royalty income	<u>67,416</u>	<u>46,711</u>
<b>Future income tax asset</b>	<u><u>\$ 134,928</u></u>	<u><u>\$ 121,839</u></u>

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**Emerald Bay Energy Inc.**  
**Notes To Financial Statements**

**December 31, 2002 and 2001**

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**9. Commitments**

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(a) Leases

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

2002	\$	26,500
2003		24,000
2004		<u>15,500</u>
	\$	<u>66,000</u>

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**10. Contingencies**

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- (a) Subsequent to the year end, the Company settled a lawsuit relating to the ownership rights of certain lateral drainhole drilling technology. The Company has accrued the \$70,000 settlement cost in these 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.
- (c) The Company is subject to various regulatory and statutory requirements relating to the protection of the environment. These requirements, in addition to contractual agreements and management decisions, result in the accrual of estimated future removal and site restoration costs. These costs are accrued on the unit of production basis. Any changes in these estimates will affect future earnings.

Costs attributable to these commitments and contingencies are expected to be incurred over an extended period of time and are to be funded mainly from the Company's cash provided by operating activities. Although the ultimate impact of these matters on net earnings cannot be determined at this time, it could be material for any one quarter or year.

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**11. Financial Instruments**

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As disclosed in Note 2(f), the Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to interest rate, commodity price 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.

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**Emerald Bay Energy Inc.**  
**Notes To Financial Statements**

**December 31, 2002 and 2001**

**11. Financial Instruments - continued**

(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, 2002, the increase or decrease in net earnings before taxes for each 1% change in interest rates on floating rate debt amounts to approximately \$4,125 (2001 - \$2,350) per annum. The related disclosure regarding these debt instruments is included in Note 5 of these financial statements.

(b) 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 (Note 13), the Company has concentrations of credit risk.

**12. Statement of Cash Flows – Supplemental Information**

(a) Interest and income taxes paid

	<b>2002</b>	2001
Interest paid	\$ 25,121	\$ 6,815
Income taxes paid	\$ -	\$ 5,764

**13. Segmented Information**

(a) The Company's activities include oil and gas production and development of certain lateral drainhole drilling technology.

<b>Description</b>			<b>Total</b>
<b>2002</b>	<b>Oil and gas production</b>	<b>Lateral drainhole drilling tech.</b>	
Petroleum and natural gas sales	\$ 829,342	\$ -	\$ 829,342
Interest revenue	\$ 42,757	\$ -	\$ 42,757
Depletion, amortization and site restoration	\$ 70,478	\$ -	\$ 70,478
Interest expense	\$ 25,121	\$ -	\$ 25,121
Income tax recovery	\$ (13,089)	\$ -	\$ (13,089)
Segment loss	\$ (214,728)	\$ (17,135)	\$ (231,863)
Capital expenditures	\$ 120,032	\$ -	\$ 120,032
Segment assets	\$ 1,309,000	\$ 70,000	\$ 1,379,000

**Emerald Bay Energy Inc.**  
**Notes To Financial Statements**

**December 31, 2002 and 2001**

**13. Segmented Information - continued**

<u>Description</u>			
2001	Oil and gas production	Lateral drainhole drilling tech.	Total
Petroleum and natural gas sales	\$ 945,802	\$ -	\$ 945,802
Interest revenue	\$ 42,757	\$ -	\$ 42,757
Depletion, amortization and site restoration	\$ 82,311	\$ -	\$ 82,311
Interest expense	\$ 6,815	\$ -	\$ 6,815
Income tax recovery	\$ (23,761)	\$ -	\$ (23,761)
Segment loss	\$ (350,581)	\$ (61,739)	\$ (288,842)
Capital expenditures	\$ 121,486	\$ -	\$ 121,486
Segment assets	\$ 1,155,689	\$ -	\$ 1,155,689

**14. Major Customers**

The Company relies upon its joint interest partner to operate on currently producing properties in which the Company has an interest. 75% (2001 – 100%) of the Company's net petroleum and natural gas sales revenue for the year ended December 31, 2002 and \$123,700 (2001 - \$48,700) in receivables as at December 31, 2002 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. 25% (2001 – nil%) of the Company's net petroleum and natural gas was sold to this purchaser in 2002. As at December 31, 2002, \$54,200 (2001 - \$nil) of the Company's receivable is due from this purchaser.

**15. Stock Compensation**

The Company does not record compensation expense when stock options are issued to employees, as disclosed in Note 2(i).

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:

Net loss	- as reported	\$ (231,863)
	- pro forma	\$ (234,863)
Loss per share	- basic and diluted	
	- as reported	\$ (0.036)
	- pro forma	\$ (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%),

**Emerald Bay Energy Inc.**  
**Notes To Financial Statements**

**December 31, 2002 and 2001**

and weighted average life of 5 years.

**16. Reissuance of 2000 and 1999 Financial Statements**

The previously issued 1999 audited financial statements did not reflect the following transactions: 1) the sale of 17.155% interest in certain oil and gas properties to certain third parties for \$240,200 on September 22, 1999; 2) the January 25, 2000 assignment of a \$218,500 promissory note due by these third parties against a promissory note payable by a consultant (subsequently an officer) of the Company in respect of Company shares he purchased from the same third parties. Subsequent to the September 22, 1999 sale, the Company continued to hold the 17.155% working interest in trust for these third parties and the Company incorrectly recorded the monthly net production payments as consulting fees rather than as a reduction of their working interest in the 1999 and 2000 financial statements. Prior to the September 22, 1999 sale, these third parties were providing consulting services to the Company.

The net effect of these unrecorded and incorrect transactions on the 2000 and 1999 financial statements was an overstatement of property and equipment, an understatement of amounts due by related parties, an overstatement of depletion and depreciation, changes to future taxes and changes to the presentation of the results in the statements of income (loss) and deficit. The statement of cash flows for these years also changed.

The changes are summarized as follows:

	Original 2000	Revised 2000	Original 1999	Revised 1999
Note receivable	\$ -	\$ 231,600	\$ -	\$ 218,500
Property and equipment	546,540	368,001	639,755	443,716
Future tax asset	56,336	64,078	-	-
Current liabilities	238,001	414,050	200,807	425,807
Deficit	(362,880)	(363,126)	(467,031)	(444,570)
Petroleum and natural gas sales	1,224,572	1,014,497	766,210	733,340
Royalties	(307,562)	(270,832)	(124,270)	(118,939)
Operating costs	270,442	232,451	313,130	304,131
General and administrative	308,601	246,327	273,802	276,970
Depletion and depreciation	147,625	130,125	177,393	133,232
Income (loss) before taxes	86,846	44,366	(285,940)	(263,479)
Income (loss) after taxes	104,151	81,444	(285,940)	(263,479)

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**Emerald Bay Energy Inc.**  
**Notes To Financial Statements**

**December 31, 2002 and 2001**

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**17. Subsequent Events**

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- (a) The Company completed the purchase of certain oil and gas assets from a company controlled by officers of the Company (Note 6(c)). As the amount of the exchange is supported by independent evidence, this transaction will be measured at the agreed to exchange amount. The purchase price is \$244,000. As the Company has already advanced this company \$89,541, a balance of \$154,459 will be paid in cash. The transaction received conditional regulatory approval on May 14, 2003 and will close effective December 31, 2002.
  - (b) The Company raised \$125,000 from the sale of 500,000 common shares at \$0.25 per share.
  - (c) The President repaid the Company \$70,000 on account of the \$79,390 loan due by him to the Company at year-end (Note 6(a)).
  - (d) The officer repaid the Company \$71,270 on account of the \$259,770 due by him to the Company at year-end (Note 6(b)). The \$71,270 payment includes \$41,270 of interest and a \$30,000 principal payment.
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