

# **Emerald Bay Energy Inc.**

Consolidated Financial Statements

**For the Years Ended December 31, 2014 and 2013**

(expressed in Canadian dollars)



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## Independent Auditor's Report

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### To the shareholders of Emerald Bay Energy Inc.

We have audited the accompanying consolidated financial statements of Emerald Bay Energy Inc., which comprise the consolidated statements of financial position as at December 31, 2014 and December 31, 2013, the consolidated statements of comprehensive loss, consolidated statements of changes in deficit and consolidated statements of cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.



### Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Emerald Bay Energy Inc. as at December 31, 2014 and December 31, 2013 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

### Emphasis of Matter

Without qualifying our opinion, we draw attention to Note 1 in the consolidated financial statements which indicates that the Company will not generate significant revenues or profitable operations in the near future and there can be no assurance that it will achieve profitability in the future, as it incurred a loss of \$1,491,385 (2013 - \$2,191,669) negative operating cash flow of \$1,196,441 for the year ended December 31, 2014 (2013 - \$1,112,254), had a working capital deficiency of \$5,398,782 (December 31, 2013 - \$4,470,072) and has accumulated \$17,420,929 of losses as at December 31, 2014 (2013 - \$15,929,544). These conditions indicate the existence of a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

BDO Canada LLP

Chartered Accountants  
Calgary, Alberta  
April 30, 2015

# Emerald Bay Energy Inc.

## Consolidated Statements of Financial Position December 31, 2014 and December 31, 2013

|  | December 31, 2014  | December 31, 2013  |
|--|--------------------|--------------------|
|  | \$                 | \$                 |
| <b>Assets</b>  |                    |                    |
| <b>Current assets</b>  |                    |                    |
| Cash and cash equivalents  | 169,556            | 160,886            |
| Short-term investments   | 59,178             | 54,256             |
| Trade and other receivables (note 19(b))                               | 241,924            | 461,087            |
| Prepaid expenses and deposits  | 36,029             | 51,401             |
| Due from related parties (note 16(a))                                  | 50,000             | 10,459             |
| <b>Total current assets</b>  | <b>556,687</b>     | <b>738,089</b>     |
| <b>Non-current assets</b>  |                    |                    |
| Due from related parties (note 16(a))                                  | 197,970            | -                  |
| Equity investment in PRI (note 6)                                      | 297,744            | 332,678            |
| Exploration and evaluation assets and other intangible assets (note 8) | 1,571,666          | 1,235,329          |
| Property and equipment (note 7)  | 253,504            | 462,210            |
| <b>Total assets</b>  | <b>2,877,571</b>   | <b>2,768,306</b>   |
| <b>Liabilities</b>   |                    |                    |
| <b>Current liabilities</b>   |                    |                    |
| Accounts payable and accrued liabilities (note 19(c))                  | 4,016,905          | 3,463,919          |
| Shareholder indemnity (note 17(c))                                     | 333,551            | 333,551            |
| Loan (note 12)   | 1,300,000          | 1,200,000          |
| Convertible debt (note 13)   | 290,025            | 159,540            |
| Current portion of vehicle loan (note 17(b))                           | 14,988             | 26,109             |
| <b>Total current liabilities</b>                                       | <b>5,955,469</b>   | <b>5,183,119</b>   |
| <b>Non-current liabilities</b>   |                    |                    |
| Long-term debt (note 17(b))  | -                  | 15,869             |
| Bank loan (note 11)  | 37,002             | -                  |
| Decommissioning obligations (note 10)                                  | 510,604            | 559,751            |
| <b>Total liabilities</b>   | <b>6,503,075</b>   | <b>5,758,739</b>   |
| <b>Shareholders' deficit</b>   |                    |                    |
| Share capital (note 14(b))   | 11,341,263         | 10,601,224         |
| Warrants (note 14(c))  | 635,113            | 675,057            |
| Contributed surplus (note 14(f))                                       | 1,824,074          | 1,664,311          |
| Deficit  | (17,420,929)       | (15,929,544)       |
| Accumulated other comprehensive loss                                   | (5,025)            | (1,481)            |
| <b>Total shareholders' deficit</b>                                     | <b>(3,625,504)</b> | <b>(2,990,433)</b> |
| <b>Total liabilities and shareholders' deficit</b>                     | <b>2,877,571</b>   | <b>2,768,306</b>   |
| <b>Reporting entity and going concern (note 1)</b>                     |                    |                    |
| <b>Commitments (note 17)</b>   |                    |                    |
| <b>Subsequent events (note 21)</b>                                     |                    |                    |

Approved on behalf of the Board of Directors

*Signed "Shelby D. Beattie"*

Director

*Signed "Gibson C. Scott"*

Director

# Emerald Bay Energy Inc.

## Consolidated Statements of Comprehensive Loss For the years ended December 31, 2014 and 2013

|   | December 31, 2014  | December 31, 2013  |
|---|--------------------|--------------------|
|   | \$                 | \$                 |
| <b>Revenue</b>  |                    |                    |
| Petroleum and natural gas revenue   | 74,811             | 168,839            |
| Royalties   | (14,076)           | (12,793)           |
| Other revenue   | -                  | 38,114             |
|   | <u>60,735</u>      | <u>194,160</u>     |
| <b>Operating expenses</b>   |                    |                    |
| Exploration and evaluation expenditures                                     | 770                | 770                |
| Production and operating expenses   | 119,205            | 137,266            |
| Depletion and depreciation (note 7)   | 54,119             | 117,254            |
| Impairment of property and equipment (note 7)                               | 359,100            | 550,596            |
| Impairment of exploration and evaluation assets (note 8)                    | 156,768            | -                  |
| Gain on disposal of property and equipment (note 7)                         | (42,380)           | -                  |
| General and administrative  | 865,999            | 1,097,517          |
| Recovery (impairment) of due from related parties (note 16(a))              | (237,511)          | (24,274)           |
| Bad debt expense (19(b))  | 43,064             | -                  |
| Foreign exchange gain (loss)  | 18,153             | 18,156             |
| Share-based payment expense (note 14(d))                                    | 7,397              | 219,964            |
|   | <u>1,344,684</u>   | <u>2,123,367</u>   |
| <b>Results from operating activities</b>                                    | <u>(1,283,949)</u> | <u>(1,929,207)</u> |
| <b>Finance expense</b>  |                    |                    |
| Interest income   | 3,104              | 20,094             |
| Interest expense  | (156,981)          | (133,132)          |
| Accretion of decommissioning obligation (note 10)                           | (17,682)           | (4,269)            |
| Loan financing expense (note 12)  | (93,710)           | (78,435)           |
| Accretion of convertible debt (note 13)                                     | (72,572)           | (133,874)          |
| Gain on removal of derivative liability (note 13)                           | 72,572             | 133,874            |
| <b>Net finance expense</b>  | <u>(265,269)</u>   | <u>(201,860)</u>   |
| <b>Other income and expenses</b>  |                    |                    |
| Gain on abandonment and reclamation (note 10)                               | 92,767             | -                  |
| Equity income (loss) on investment in PRI (note 6)                          | (34,934)           | (19,722)           |
| <b>Net other income and expenses</b>  | <u>57,833</u>      | <u>(19,722)</u>    |
| <b>Net loss for the year</b>  | <u>(1,491,385)</u> | <u>(2,150,789)</u> |
| <b>Other comprehensive (loss) income</b>                                    |                    |                    |
| Foreign currency translation adjustment                                     | (3,544)            | 1,143              |
| <b>Total comprehensive loss for the year</b>                                | <u>(1,494,929)</u> | <u>(2,149,646)</u> |
| <b>Basic and fully diluted loss per share (note 14(g))</b>                  | <b>(0.01)</b>      | <b>(0.02)</b>      |
| <b>Weighted average number of common shares outstanding during the year</b> | <b>147,347,803</b> | <b>138,646,073</b> |

# Emerald Bay Energy Inc.

## Statements of Changes in Deficit

### For the years ended December 31, 2014 and 2013

|   | Share capital<br>\$ | Warrants<br>\$ | Contributed<br>surplus<br>\$ | Deficit<br>\$ | Accumulated other<br>comprehensive loss<br>\$ | Total deficit<br>\$t |
|---|---------------------|----------------|------------------------------|---------------|---|----------------------|
| <b>Balance, December 31, 2012</b>                                 | 9,806,332           | 1,274,721      | 1,135,960                    | (13,778,755)  | (2,624)                                       | (1,564,366)          |
| Proceeds received pursuant to private placements                  | 256,312             | 141,188        | -                            | -             | -   | 397,500              |
| Cash share issue costs  | (24,672)            | (13,587)       | -                            | -             | -   | (38,259)             |
| Finders options issued  | (10,844)            | (5,974)        | 16,817                       | -             | -   | -                    |
| Expiry of warrants  | 574,096             | (574,096)      | -                            | -             | -   | -                    |
| Expiry of warrants issued pursuant to loan                        | -                   | (147,195)      | 147,195                      | -             | -   | -                    |
| Share-based payment expense                                       | -                   | -              | 219,964                      | -             | -   | 219,964              |
| Loss for the year   | -                   | -              | -                            | (2,150,789)   | -   | (2,150,789)          |
| Gain on sale of property (note 6)                                 | -                   | -              | 144,375                      | -             | -   | 144,375              |
| Foreign exchange translation to presentation currency             | -                   | -              | -                            | -             | 1,143   | 1,143                |
| <b>Balance, December 31, 2013</b>                                 | 10,601,224          | 675,057        | 1,664,311                    | (15,929,544)  | (1,481)                                       | (2,990,433)          |
| Proceeds received pursuant to private placements                  | 87,490              | 759,435        | -                            | -             | -   | 846,925              |
| Cash share issue costs  | (13,517)            | (74,657)       | -                            | -             | -   | (88,174)             |
| Finders options issued  | (8,991)             | (49,665)       | 58,656                       | -             | -   | -                    |
| Reallocation expiry of warrants                                   | 809,550             | (809,550)      | -                            | -             | -   | -                    |
| Issue costs for expired warrant                                   | (134,493)           | 134,493        | -                            | -             | -   | -                    |
| Reallocation expiry of warrants issued pursuant to Loan (note 12) | -                   | 93,710         | -                            | -             | -   | 93,710               |
| Expiry of warrants issued pursuant to Loan                        | -                   | (93,710)       | 93,710                       | -             | -   | -                    |
| Share-based payment expense                                       | -                   | -              | 7,397                        | -             | -   | 7,397                |
| Loss for the year   | -                   | -              | -                            | (1,491,385)   | -   | (1,491,385)          |
| Foreign exchange translation to presentation currency             | -                   | -              | -                            | -             | (3,544)                                       | (3,544)              |
| <b>Balance, December 31, 2014</b>                                 | 11,341,263          | 635,113        | 1,824,074                    | (17,420,929)  | (5,025)                                       | (3,625,504)          |

# Emerald Bay Energy Inc.

## Consolidated Statements of Cash Flows

For the years ended December 31, 2014 and 2013

|  | December 31, 2014  | December 31, 2013  |
|--|--------------------|--------------------|
|  | \$                 | \$                 |
| <b>Cash (used in) provided by:</b>                                       |                    |                    |
| <b>Operating activities</b>  |                    |                    |
| Net loss for the year  | (1,491,385)        | (2,150,789)        |
| Adjustments for:   |                    |                    |
| Depletion and depreciation (note 7)                                      | 54,119             | 117,254            |
| Impairment of property and equipment (note 7)                            | 359,100            | 550,596            |
| Impairment of E&E assets (note 8)  | 156,768            | -                  |
| Loan financing expense (note 12)   | 93,710             | 78,435             |
| Accretion of convertible debt (note 13)                                  | 72,572             | 133,874            |
| Gain on removal of derivative liability (note 13)                        | (72,572)           | (133,874)          |
| Accretion of decommissioning obligation (note 10)                        | 17,682             | 4,269              |
| Gain on abandonment and reclamation (note 10)                            | (92,767)           | -                  |
| Gain on disposal of property and equipment (note 7)                      | (42,380)           | -                  |
| Equity pick-up on investment in PRI (note 6)                             | 34,934             | 19,722             |
| Unrealized foreign exchange  | (99,172)           | 30,576             |
| Recovery (impairment) of due from related parties (note 16(a))           | (237,511)          | 17,719             |
| Bad debt expense recovery (note 19(b))                                   | 43,064             | -                  |
| Share-based payment expense (note 14(d))                                 | 7,397              | 219,964            |
|  | <u>(1,196,441)</u> | <u>(1,112,254)</u> |
| Change in accounts receivable  | 176,099            | 140,737            |
| Change in prepaid expenses and deposits                                  | 15,372             | 4,195              |
| Change in accounts payable and accrued liabilities                       | 305,655            | 935,644            |
| Change in shareholder indemnity (note 17(c))                             | -                  | 12,054             |
|  | <u>(699,315)</u>   | <u>(19,622)</u>    |
| <b>Investing activities</b>  |                    |                    |
| Property and equipment expenditures (note 7)                             | (136,196)          | (19,874)           |
| Exploration and evaluation expenditures (note 8)                         | (376,515)          | (850,754)          |
| Proceeds received on disposal of oil and natural gas interests (note 7)  | -                  | 172,882            |
| Change in short-term investments   | (4,922)            | (4,511)            |
| Repayment of advanced funds to PRI                                       | -                  | 215,906            |
| Change in accounts payable and accrued liabilities                       | 247,331            | (199,023)          |
|  | <u>(270,302)</u>   | <u>(686,174)</u>   |
| <b>Financing activities</b>  |                    |                    |
| Proceeds from issuance of common shares, net of issue costs (note 14(b)) | 758,751            | 359,240            |
| Repayment of long term debt  | (26,990)           | (24,688)           |
| Receipt of loan (note 12)  | 100,000            | -                  |
| Receipt of convertible debt (note 13)                                    | 109,524            | -                  |
| Receipt of bank loan (note 11)   | 37,002             | -                  |
|  | <u>978,287</u>     | <u>334,552</u>     |
| <b>Change in cash and cash equivalents</b>                               | <b>8,670</b>       | <b>(371,244)</b>   |
| <b>Cash and cash equivalents, beginning of year</b>                      | <b>160,886</b>     | <b>532,130</b>     |
| <b>Cash and cash equivalents, end of year</b>                            | <b>169,556</b>     | <b>160,886</b>     |

Supplemental cash flow information (Note 18)

# **Emerald Bay Energy Inc.**

Notes to the Consolidated Financial Statements  
For the years ended December 31, 2014 and 2013

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## **1 Reporting entity and going concern**

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. The Company is listed on the TSX Venture exchange under the symbol “EBY.V”. The Company’s registered head office is located at #3A, 4015 – 1 Street South East, Calgary, Alberta, Canada T2G 4X7.

At December 31, 2014, the Company had not yet achieved profitable operations, had an accumulated a deficit of \$17,420,929 since its inception (December 31, 2013 - \$15,929,544), had negative cash flows from operations of \$699,315 (December 31, 2013 - \$19,622) and had a working capital deficiency of \$5,398,782 (December 31, 2013 - \$4,445,030) (defined as current assets less current liabilities), and expects to incur further losses in the development of its business. 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. All of these factors, together with weak natural gas prices and the current unstable economic conditions, indicate the existence of material uncertainties related to events or conditions that may cast significant doubt as to whether the Company can continue as a going concern and, therefore, it may be unable to realize its assets and discharge its liabilities in the normal course of business. These consolidated financial statements do not reflect the adjustments to the carrying value of assets and liabilities, the reported revenues and expenses, and the balance sheet classifications that would be necessary if the going concern assumption was not appropriate. Any adjustments necessary to the consolidated financial statements if the Company ceases to be a going concern could be material.



# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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### **2 Basis of presentation**

a) Statement of compliance:

These annual Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”).

The Board of Directors approved the consolidated financial statements on April 30, 2015.

b) Basis of measurement:

The Consolidated Financial Statements have been prepared on the historical cost basis except for derivative financial instruments, which are measured at fair value, as explained in note 3 – Significant Accounting Policies.

c) Basis of consolidation:

These consolidated financial statements include the accounts of the Company and its US branch and Emerald Bay Texas Inc., its wholly-owned and controlled subsidiary. Control exists when the Company has the power over the investee, exposure or rights to variable returns from its involvement and has the ability to affect those returns through its power over the investee. The financial statements of subsidiaries, including entities which the Company controls, are included in the consolidated financial statements from the date that control commences until the date that control ceases. The financial statements of the subsidiaries are prepared for the same reporting period as the Company, using consistent accounting policies. All intercompany transactions and balances have been eliminated.

d) Nature and purpose of equity and reserves:

The reserves recorded in equity on the Company’s consolidated Statement of Financial Position include ‘Contributed Surplus’, ‘Accumulated Other Comprehensive Loss’, and ‘Accumulated Deficit’.

‘Contributed Surplus’ is used to recognize the value of stock options and broker warrants prior to exercise.

‘Accumulated Other Comprehensive Loss’ is the foreign exchange gain or loss resulting from the translation of the Corporation’s foreign subsidiary.

‘Accumulated Deficit’ is used to record the Corporation’s change in deficit from profit or loss from year to year.

# **Emerald Bay Energy Inc.**

Notes to the Consolidated Financial Statements  
For the years ended December 31, 2014 and 2013

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e) Use of estimates and judgments:

The preparation of the Consolidated Financial Statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. By their nature, these estimates are subject to measurement uncertainty and the effect on the Consolidated Financial Statements of changes in such estimates in future periods could be significant.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

Significant judgments

*Determination of cash-generating units (“CGU”)*

Property and equipment are aggregated into CGUs based on their ability to generate largely independent cash flows and are used for impairment testing. The determination of the Company’s CGUs is subject to management’s judgment.

Significant estimates and assumptions

*Reserves*

Oil and gas development and production properties are depleted on a unit of production basis at a rate calculated by reference to proved reserves determined in accordance with the Society of Petroleum Engineers rules and incorporating the estimated future cost of developing and extracting those reserves. Oil and gas reserves are also used to evaluate impairment of developed property and equipment (“PP&E properties”). Commercial reserves are determined using estimates of oil and natural gas in place, recovery factors, discount rates and forward future prices. Future development costs are estimated using assumptions as to the number of wells required to produce the commercial reserves, the cost of such wells and associated production facilities, and other capital costs. There are numerous uncertainties inherent in estimating oil and gas reserves. Estimating reserves is very complex, requiring many judgments based on geological, geophysical, engineering and economic data. These estimates may change, having either a positive or negative impact on the statement of comprehensive loss as further information becomes available and as the economic environment changes.

# **Emerald Bay Energy Inc.**

Notes to the Consolidated Financial Statements  
For the years ended December 31, 2014 and 2013

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## *Decommissioning liabilities*

The Company estimates the decommissioning obligations for oil and natural gas wells and their associated production facilities and pipelines. In most instances, removal of assets and remediation occurs many years into the future. Amounts recorded for the decommissioning obligations and related accretion expense require estimates regarding removal date, future environmental legislation, the extent of reclamation activities required, the engineering methodology for estimating costs, future removal technologies in determining the removal costs, and discount rates to determine the present value of these cash flows.

## *Exploration and evaluation ("E&E") assets*

The accounting policy for E&E assets is described in note 3. The application of this policy requires management to make certain estimates and assumptions as to future events and circumstances as to whether economic quantities of reserves will be found.

## *Share-based compensation*

The fair value of stock options and warrants granted is recognized using the Black-Scholes option pricing model. Measurement inputs include the Company's share price on the measurement date, the exercise price of the option, the expected volatility of the Company's shares, the expected life of the options, expected dividends and the risk-free rate of return. The Company estimates volatility based on the historical share price in the publicly traded markets. The expected life of the options is based on historical experience and estimates of the holder's behavior. Dividends are not factored in as the Company does not expect to pay dividends in the foreseeable future. Management also makes an estimate of the number of options that will be forfeited and the rate is adjusted to reflect the actual number of options that vest.

## *Recoverability of assets*

The Company assesses impairment on its assets that are subject to amortization when it has determined that a potential indicator of impairment exists. Impairment exists when the carrying value of a non-financial asset or CGU exceeds its recoverable amount, which is the higher of its fair value less costs to sell and its value in use. The Company used the calculation of fair value less costs to sell to determine the fair value of its CGUs. In determining the fair value less costs to sell, the amount is most sensitive to the future commodity prices, discount rates, and estimates of proved and probable reserves, to determine an implied fair value of the CGU being tested.

# **Emerald Bay Energy Inc.**

Notes to the Consolidated Financial Statements  
For the years ended December 31, 2014 and 2013

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## **3 Significant accounting policies**

The accounting policies set out below have been applied consistently to all years presented in these Consolidated Financial Statements.

### **Cash and cash equivalents**

Cash and cash equivalents include cash on hand and deposits held with banks. Bank overdrafts that are repayable on demand and form an integral part of the Company's cash management, whereby management has the legally enforceable right and ability and intent to net bank overdrafts against cash, are included as a component of cash for the purpose of the statement of cash flows. Cash equivalents comprise term deposits held with banks and other short-term highly liquid investments with original maturities of three months or less.

### **Financial instruments**

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risk and rewards of ownership. Financial assets and liabilities are offset and the net amount is reported in the statement of financial position when there is a legally enforceable right to offset the recognized amount and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

Common shares are classified as equity. Incremental costs directly attributable to the issuance of common shares are recognized as a deduction from equity, net of any tax effects.

# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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### *Non-derivative financial instruments:*

Non-derivative financial instruments include cash and cash equivalents, short-term investments, trade and other receivables, due from related parties, accounts payable and accrued liabilities, shareholder indemnity, the loan, convertible debt, bank loan and long-term debt. Non-derivative financial instruments are recognized initially at fair value. Subsequent to the initial recognition, non-derivative financial instruments are designated into one of the following categories and measured as described below:

- (i) Financial assets and liabilities at fair value through profit or loss: Financial assets and liabilities at fair value through profit or loss are either “held for trading” or have been “designated at fair value through profit of loss”. In both cases the financial assets and financial liabilities are measured at fair value with changes in fair value recognized in the statement of comprehensive loss. A financial asset or liability is classified in this category if acquired principally for the purpose of selling or repurchasing in the short-term. Transaction costs are expensed in the statement of comprehensive loss.

The Company has designated its’ cash and cash equivalents and short-term investments in this category.

- (ii) Loans and receivables: Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The Company’s loans and receivables are comprised of trade and other receivables and due from related parties and are included in current assets due to their short-term nature. Loans and receivables are initially recognized at the amount expected to be received less, when material, a discount to reduce the loans and receivables to fair value. Transaction costs pertaining to these financial instruments are added to the financial instrument. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment.
- (iii) Financial liabilities at amortized cost: Financial liabilities at amortized cost include accounts payable and accrued liabilities, shareholder indemnity, the loan, convertible debt, bank loan, and long-term debt. Accounts payable and accrued liabilities are initially recognized at the amount required to be paid less, when material, a discount to reduce the payables to fair value. Subsequently, accounts payable and accrued liabilities and the shareholder indemnity are measured at amortized cost using the effective interest method. The loan, the convertible debt, (excluding the derivative relating to the conversion option), the bank loan, the current portion of long-term debt and the long-term debt are recognized initially at fair value and subsequently at amortized cost using the effective interest method. The fair value of transaction costs to acquire debt are netted against the debt instrument and through a non-cash finance expense, the debt is accreted back to the principal balance over the life of the debt.

# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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Financial liabilities are classified as current liabilities if payment is due within twelve months. Otherwise, they are presented as non-current liabilities.

### *Derivative financial instruments:*

The Company may enter into certain financial derivative contracts in order to manage the exposure to market risks from fluctuations in commodity prices. These instruments are not used for trading or speculative purposes. As a result, all financial derivative contracts are classified as fair value through profit or loss and are recorded on the statement of financial position at fair value. Transaction costs are recognized in the statement of comprehensive loss when incurred.

Embedded derivatives are separated from the host contract and accounted for separately if the economic characteristics and risks of the host contract and the embedded derivative are not closely related. Conversion features that are accounted for as derivative liabilities are accounted for separately from the host instrument as the fair value of the conversion feature is affected by changes in the fair value of the Company's shares, and the fair value of the host instrument is not. Changes in the fair value of separable embedded derivatives are recognized immediately in the statement of comprehensive loss.

### **Property and equipment and exploration and evaluation assets**

#### *Recognition and measurement:*

(i) Exploration and evaluation expenditures:

Pre-license costs are recognized in the statement of comprehensive loss as incurred.

All costs associated with the exploration and evaluation of oil and natural gas reserves are initially capitalized. Exploration and evaluation costs are those expenditures for an area where technical feasibility and commercial viability has not yet been determined. These costs include unproved property acquisition costs, exploration costs, geological and geophysical costs, decommissioning costs, exploration and evaluation drilling, and sampling and appraisals.

When an area is determined to be technically feasible and commercially viable the accumulated costs are tested for impairment and transferred to property and equipment. When an area is determined not to be technically feasible and commercially viable or the Company decides not to continue with its activity, the unrecoverable costs are charged to the statement of comprehensive loss as exploration and evaluation expense.

# **Emerald Bay Energy Inc.**

Notes to the Consolidated Financial Statements  
For the years ended December 31, 2014 and 2013

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(ii) Property and equipment:

All costs directly associated with the development of oil and gas reserves are capitalized on an area-by-area basis. Development costs include expenditures for areas where technical feasibility and commercial viability has been determined. These costs include proved property acquisitions, development drilling, completion, gathering and infrastructure, decommissioning costs and transfers of exploration and evaluation assets.

Costs accumulated within each area are depleted using the unit-of-production method based on proven reserves incorporating estimated future prices and costs. Costs subject to depletion include estimated future costs to be incurred in developing proven reserves. Costs of major development projects are excluded from the costs subject to depletion unless they are available for use.

Gains and losses on disposal of an item of property and equipment, including oil and natural gas interests, are determined by comparing the proceeds from disposal with the carrying amount of property and equipment and are recognized within "other income and expenses" in profit or loss.

(iii) Other property and equipment:

Other property and equipment is carried at cost and amortized over the estimated useful lives of the assets at various rates per annum calculated on a declining balance basis. Amortization is charged at half rates in the year of acquisition.

The Company uses the following rates:

| <b>Asset class</b>                                 | <b>Rate</b> |
|--|-------------|
| Furniture and equipment and leasehold improvements | 20%         |
| Computer Hardware                                  | 30%         |
| Automotive   | 30%         |

*Subsequent costs:*

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of property and equipment are recognized as oil and natural gas interests only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures are recognized in the profit and loss as incurred. Such capitalized oil and natural gas interests generally represent costs incurred in developing proved and/or probable reserves and bringing in or enhancing production from such reserves, and are accumulated on a field or geotechnical area basis. The carrying amount of any replaced or sold component is derecognized. The costs of the day-to-day servicing of property and equipment are recognized in profit or loss as incurred.

# **Emerald Bay Energy Inc.**

Notes to the Consolidated Financial Statements  
For the years ended December 31, 2014 and 2013

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## **Impairment**

### *Financial assets:*

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset. Objective evidence that financial assets are impaired can include: significant financial difficulty of the issuer or counterparty; the potential for loss is significant; a prolonged decline in value (defined as a decline in value lasting longer than one year); default or delinquency of payments; or it is probable that the borrower will enter bankruptcy or financial re-organization.

- (i) Financial assets carried at amortized cost: An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount and the present value of the estimated future cash flows discounted at the original effective interest rate. The carrying amount of the asset is reduced by this amount and losses are recognized in profit or loss and through the use of an allowance account.
- (ii) Available for sale financial assets: The impairment loss is the difference between the original cost of the asset and its fair value at the measurement date, less any impairment losses previously recognized in profit or loss. This amount represents the cumulative loss in accumulated other comprehensive income that is reclassified to the statement of comprehensive loss.

Impairment losses on financial assets carried at amortized cost are reversed in subsequent periods if the reversal can be related objectively to an event occurring after the impairment loss was recognized. The reversal is recognized in profit or loss or credited against the allowance account. Impairment losses on available for sale equity instruments are not reversed.

### *Non-financial assets:*

The carrying amounts of the Company's non-financial assets, other than E&E assets and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. For other intangible assets that have indefinite lives or that are not yet available for use an impairment test is completed each year. E&E assets are assessed for impairment when they are reclassified to property and equipment, as oil and natural gas interests, and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For the purpose of impairment testing, assets are grouped together into the smallest group of assets that generate cash inflows from continuing use that are largely independent of the cash



# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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inflows of other assets or groups of assets (the “CGU”). The Company considers its Canadian assets as a CGU and its Texas assets as a separate CGU.

The recoverable amount of an asset or a CGU is the greater of its value in use and its fair value less costs to sell (“FVLCTS”). Value in use is determined by estimating the present value of the future net cash flows expected to be derived from the continued use of the asset or CGU. FVLCTS is based on available market information, where applicable. In the absence of such information, FVLCTS is determined using discounted future net cash flows of proved and probable reserves using forecast prices and costs.

An impairment loss is recognized if the carrying amount of an asset or its CGU exceeds its estimated recoverable amount. Impairment losses are recognized in profit or loss. Impairment losses recognized in respect of CGUs are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amounts of the other assets in the unit (group of units) on a pro rata basis.

### **Share-based payments**

The Company issues stock options to directors, officers and other consultants, which are deemed employees. The fair value of options granted to employees is measured at grant date, using the Black-Scholes option pricing model, and is recognized over the vesting period, using a graded vesting model. The fair value is recognized as an expense within operations with a corresponding increase in contributed surplus. A forfeiture rate is estimated on the grant date and is adjusted to reflect the actual number of options that vest.

The fair value of the warrants issued as part of the private placements is measured at the closing date of the private placement, using the Black-Scholes option pricing model. The fair value is recognized as a deduction against share capital with a corresponding increase in contributed surplus.

If and when the stock options and/or warrants are ultimately exercised, the applicable amounts of contributed surplus are transferred to share capital.

### **Provisions**

A provision is recognized if, as a result of a past event, the Company has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. Provisions are not recognized for future operating losses.

# **Emerald Bay Energy Inc.**

Notes to the Consolidated Financial Statements  
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## **Decommissioning liabilities**

The Company's activities give rise to dismantling, decommissioning and site disturbance remediation activities. Provision is made for the estimated cost of site restoration and capitalized in the relevant asset category.

Decommissioning obligations are measured at the present value of management's best estimate of expenditure required to settle the present obligation at the statement of financial position date. Subsequent to the initial measurement, the obligation is adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. The increase in the provision due to the passage of time is recognized as finance costs whereas increases/decreases due to changes in the estimated future cash flows are capitalized. Actual costs incurred upon settlement of the decommissioning liabilities are charged against the provision to the extent the provision was established.

## **Revenue**

Revenue from the sale of oil and natural gas is recorded when the significant risks and rewards of ownership of the product are transferred to the buyer which is usually when legal title passes to the external party. This is generally at the time product enters the pipeline.

Royalty income is recognized as it accrues in accordance with the terms of the overriding royalty agreements.

## **Finance income and expenses**

Finance expense comprises interest expense on borrowings, accretion of the discount on provisions and impairment on related party loans and receivables.

Finance income which comprises interest income is recognized as it accrues in the statement of comprehensive loss, using the effective interest method.

## **Income tax**

Income tax expense comprises current and deferred tax. Income tax expense is recognized in profit or loss except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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Deferred tax is recognized using the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized on the initial recognition of assets or liabilities in a transaction that is not a business combination. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

### **Earnings per share**

Basic earnings per share is calculated by dividing the profit or loss attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the period. Diluted earnings per share is determined by adjusting the profit or loss attributable to common shareholders and the weighted average number of common shares outstanding for the effects of dilutive instruments such as options granted to employees.

### **Currency translation**

#### *Functional and presentation currency*

The functional currency for each branch within the Company is the currency of the primary economic environment in which it operates. The functional currency for the United States branch is the United States dollar. The functional currency of the Canadian branch is the Canadian dollar. These Consolidated Financial Statements are presented in Canadian dollars. Intercompany balances and transactions, and any unrealized income and expenses arising from intercompany transactions, are eliminated in preparing the Consolidated Financial Statements.

The results and financial position of the subsidiaries that have a functional currency different from the presentation currency are translated into Canadian dollars, the presentation currency, as follows:

- Assets and liabilities are translated at the closing exchange rate at the date of the statement of financial position;
- Income and expenses are translated at the average exchange rates during the period; and
- All resulting exchange differences are charged/credited to the currency translation adjustment in other comprehensive loss.

# **Emerald Bay Energy Inc.**

Notes to the Consolidated Financial Statements  
For the years ended December 31, 2014 and 2013

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## *Transactions and balances*

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the date of the transaction. Generally, foreign exchange gains and losses resulting from the settlement of foreign currency transactions and from the translation of monetary assets and liabilities, within the US branch, denominated in currencies other than an operation's functional currency are recognized in profit or loss.

## **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 by the Company and the investment account of the Company is also increased or decreased to reflect the Company's 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.

## **Flow-through shares**

From time to time the Company will issue flow-through common shares to finance a portion of its exploration program. These shares transfer the tax deductibility of qualifying resource expenditures to investors. On issuance, the Company splits the flow-through shares into i) a flow-through share premium, equal to the estimated premium, if any, investors pay for the flow-through feature, which is recognized as a liability, and ii) share capital. When expenses are renounced, the Company derecognizes the liability and recognizes a deferred tax liability for the amount of tax reduction renounced to the shareholders. The premium is recognized as other income and the related deferred tax is recognized as a tax provision.

Proceeds received from the issuance of flow-through shares are restricted to be used only for Canadian resource property exploration expenditures. The Company may also be subject to a Part XII.6 tax on flow-through proceeds renounced under the Look-back Rule, in accordance with Government of Canada flow-through regulations. When applicable, this tax is accrued as a financial expense until paid.

## **Jointly controlled operations**

Substantially all of the Partnership's exploration and production and power plant activities are conducted under joint operating agreements, whereby two or more parties jointly control the assets. These consolidated financial statements reflect only the Partnership's share of these jointly controlled assets and, once production commences, a proportionate share of the relevant revenue and related costs.

# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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### **4 Recent accounting pronouncements**

The following pronouncements and amendments are effective for annual periods beginning on or after January 1, 2014 unless otherwise stated. Adopting these standards has had minimal or no impact on the Company's Consolidated Financial Statements.

IAS 32 – “Financial Instruments: Presentation”, the amendments clarify that the right to offset financial assets and liabilities must be available on the current date and cannot be contingent on a future event. The adoption of IAS 32 did not impact the Consolidated Financial Statements.

IAS 36 – “Impairment of Assets” which reduces the circumstances in which the recoverable amount of CGUs is required to be disclosed and clarify the disclosures required when an impairment loss has been recognized or reversed in the period. These amendments have been applied by the Company on January 1, 2014 and the adoption only impacts the Company's disclosures in the notes to the consolidated financial statements in periods when an impairment loss or impairment reversal is recognized.

IFRIC 21 – “Levies” which clarifies that an entity recognizes a liability for a levy when the activity that triggers payment, as identified by the relevant legislation, occurs. The interpretation also clarifies that no liability should be recognized before the specified minimum threshold to trigger that levy is reached. The adoption of this interpretation did not have an impact on the Company's consolidated financial statements.

The Company has reviewed the new and revised accounting pronouncements that have been issued but are not yet effective and determined that the following may have an impact on the Company. The Company has not quantified the effect of the following:

IFRS 15 – “Revenue from Contracts with Customers”, replaces International Accounting Standard 11, “Construction Contracts” (“IAS 11”), IAS 18, “Revenue” (“IAS 18”), and several revenue-related interpretations. IFRS 15 establishes a single revenue recognition framework that applies to contracts with customers. The standard requires an entity to recognize revenue to reflect the transfer of goods and services for the amount it expects to receive, when control is transferred to the purchaser. Disclosure requirements have also been expanded. This IFRS becomes effective for annual periods beginning on or after January 1, 2017 with earlier adoption permitted. The standard may be applied retrospectively or using a modified retrospective approach. The Company is currently evaluating the impact of adopting IFRS 15 on the Consolidated Financial Statements.

IFRS 9 – “Financial Instruments”, which is the result of the first phase of the IASB's project to replace IAS 39 – “Financial Instruments: Recognition and Measurement”. The new standard replaces the current multiple classification and measurement models for financial assets and

# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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liabilities with a single model that has only two classification categories: amortized cost and fair value. This IFRS becomes effective for periods beginning on or after January 1, 2018. The Company has not yet begun the process of assessing the impact that the new standard will have on its financial statements.

### **5 Determination of fair values**

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. When applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

#### *Property and equipment and E&E assets:*

The fair value of property and equipment and E&E is the estimated amount for which property and equipment could be exchanged on the acquisition date between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties each acted knowledgeably, prudently and without compulsion. The fair value of oil and natural gas assets (included in property and equipment) is estimated with reference to the discounted cash flows expected to be derived from oil and natural gas production based on externally prepared reserve reports. The risk-adjusted discount rate is specific to the asset with reference to general market conditions.

#### *Cash and cash equivalents, trade and other receivables and accounts payable and accrued liabilities:*

At December 31, 2014 and December 31, 2013, the fair value of these balances approximated their carrying value due to their short term to maturity.

#### *Share-based payments, warrants and finder's options:*

The fair value of employee stock options, warrants and the finder's options are measured using a Black Scholes option pricing model. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility (based on weighted average historic volatility adjusted for changes expected due to publicly available information), weighted average expected life of the instruments (based on historical experience and general option holder behavior), expected dividends, and the risk-free interest rate (based on government bonds).

### **6 Equity investment in PRI**

The Company continued to have a 25% ownership interest in Production Resources Inc ("PRI"). The Company has accounted for the investment using the equity method.

# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

During the year ended December 31, 2011, the Company advanced an additional \$215,906 to PRI, which was deemed to form part of the value of the Company's net investment in PRI. During the year ended December 31, 2013, PRI repaid the advanced funds in full, including accrued interest of \$29,135. As at December 31, 2014, the Company maintains a 25% ownership in PRI based on the 25% ownership in the share capital of PRI.

The investment in PRI as at December 31, 2014 is as follows:

|   | CDN \$    |
|---|-----------|
| <b>Net investment, December 31, 2012</b>          | 568,306   |
| Proportionate share of income (loss) for the year | (19,722)  |
| Repayment of advanced funds                       | (215,906) |
| <b>Net investment, December 31, 2013</b>          | \$332,678 |
| Proportionate share of income (loss) for the year | (34,934)  |
| <b>Net investment, December 31, 2014</b>          | \$297,744 |

Summarized financial information for PRI as at and for the year ended December 31, 2014, is presented in the following table. The amounts have been translated from PRI's reporting currency of USD to CAD at the December 31, 2014 exchange rate of \$1.1601 and the average rate for the year ended December 31, 2014 \$1.1046:

|  | USD\$     | CAD\$     |
|--|-----------|-----------|
| <b>Current Assets</b>                  |           |           |
| Cash                                   | 9,968     | 11,564    |
| Other current assets                   | 378,712   | 439,344   |
|  | 388,680   | 450,908   |
| <b>Property and equipment</b>          | 3,426,854 | 3,975,493 |
| <b>Total assets</b>                    | 3,815,534 | 4,426,401 |
| <b>Current liabilities</b>             |           |           |
| Trade and other accounts payable       | 454,384   | 527,131   |
| Other current liabilities              | 2,483     | 2,881     |
|  | 456,867   | 530,012   |
| <b>Long term debt</b>                  | 3,626,606 | 4,207,226 |
| <b>Total liabilities</b>               | 4,083,473 | 4,737,238 |
|  |           |           |
|  | USD\$     | CAD\$     |
| Revenue                                | 1,707,010 | 1,885,563 |
| Operating expenses                     | 665,801   | 735,444   |
| Depletion and depreciation             | 312,928   | 345,660   |
| Interest expense                       | 360,893   | 398,642   |
| General and admin                      | 520,841   | 575,321   |
| <b>Net loss and comprehensive loss</b> | (153,453) | (169,504) |

# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

### 7 Property and equipment

|   | Oil and natural gas<br>interests<br>\$ | Power plant<br>interests<br>\$ | Corporate and<br>Other<br>\$ | Total<br>\$ |
|---|--|--------------------------------|------------------------------|-------------|
| <b>Cost, December 31, 2013</b>  | 4,306,882                              | -                              | 317,297                      | 4,624,179   |
| Additions   | 72,088                                 | 120,389                        | 4,644                        | 197,121     |
| Revisions in decommissioning liability                                | 22,995                                 | -                              | -                            | 22,995      |
| Disposal of oil and natural gas interests                             | (16,339)                               | -                              | -                            | (16,339)    |
| Foreign currency translation  | -                                      | -                              | 1,234                        | 1,234       |
| <b>Cost, December 31, 2014</b>  | 4,385,626                              | 120,389                        | 323,175                      | 4,829,190   |
| Accumulated depletion, depreciation and impairment, beginning of year | (3,904,320)                            | -                              | (257,649)                    | (4,161,969) |
| Depreciation and depletion for the period                             | (37,213)                               | -                              | (16,906)                     | (54,119)    |
| Impairment of oil and natural gas interests                           | (359,100)                              | -                              | -                            | (359,100)   |
| Foreign currency translation  | -                                      | -                              | (498)                        | (498)       |
| <b>Carrying value, December 31, 2014</b>                              | 84,993                                 | 120,389                        | 48,122                       | 253,504     |
|   |  |                                |                              |             |
|   | Oil and natural gas<br>interests<br>\$ | Power plant<br>Interests<br>\$ | Corporate and<br>Other<br>\$ | Total<br>\$ |
| <b>Cost, December 31, 2012</b>  | 4,241,841                              | -                              | 307,436                      | 4,549,277   |
| Additions   | 10,552                                 | -                              | 9,322                        | 19,874      |
| Revisions in decommissioning liability                                | 387,036                                | -                              | -                            | 387,036     |
| Disposal of oil and natural gas interests                             | (316,757)                              | -                              | -                            | (316,757)   |
| Foreign currency translation  | (15,850)                               | -                              | 539                          | (15,311)    |
| <b>Cost, December 31, 2013</b>  | 4,306,882                              | -                              | 317,297                      | 4,624,119   |
| Accumulated depletion, depreciation and impairment, beginning of year | (3,541,668)                            | -                              | (236,084)                    | (3,777,752) |
| Depreciation and depletion for the year                               | (95,864)                               | -                              | (21,390)                     | (117,254)   |
| Disposal of oil and natural gas interests                             | 283,868                                | -                              | -                            | 283,868     |
| Impairment of oil and natural gas interests                           | (550,965)                              | -                              | -                            | (550,965)   |
| Foreign currency translation  | (83)                                   | -                              | (92)                         | (175)       |
| <b>Carrying value, December 31, 2013</b>                              | 402,562                                | -                              | 59,648                       | 462,210     |

During the year ended December 31, 2014, the Company entered into an agreement (the "Agreement") to develop, own and operate a natural gas fired electrical power generation plant (the "Power Plant"). Pursuant to the Agreement, the existing partners of certain wells agreed to contract all of their working interest shares of gas production from these wells as fuel for the Power Plant. Pursuant to the Agreement, the Company disposed of a portion of their working interest to the operator through a non-cash transaction in lieu of paying its portion of capital costs to develop the Power Plant. The deemed fair value of the acquired Power Plant interest was determined to be \$44,625. The carrying value of the working interest surrendered, was \$2,245 (including decommissioning liability of \$14,094). Accordingly, a gain on the disposition of \$42,380 was recorded in the statement of comprehensive loss. The Company is committed to contributing to the capital costs of the Power Plant if the costs of



# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

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development are in excess of the budgeted amount. At December 31, 2014, the Company contributed \$75,764 to the development of the Power Plant.

During the year ended December 31, 2013, the Company disposed of various US oil and gas interests to PRI, which a related party, for proceeds of \$172,882. The proceeds received were greater than the carrying amount of the assets of \$28,507, which was recorded to contributed surplus.

### 8 Exploration and evaluation assets

|  | E&E assets |
|--|------------|
|  | \$         |
| <b>Balance, December 31, 2012</b>      | 397,668    |
| Additions                              | 849,813    |
| Revisions in decommissioning liability | (13,093)   |
| Foreign currency translation           | 941        |
| <b>Balance, December 31, 2013</b>      | 1,235,329  |
| Additions                              | 381,015    |
| Revisions in decommissioning liability | 4,300      |
| Impairment (note 9)                    | (156,768)  |
| Foreign currency translation           | 112,290    |
| <b>Balance, December 31, 2014</b>      | 1,571,666  |

E&E assets consist of the Company's exploration projects which are pending the determination of technological feasibility and commercial viability. As at December 31, 2014, the Company incurred an amount of \$381,015 on E&E expenditures (December 31, 2013 - \$849,813). The additions represent the acquisition of undeveloped land and drilling activity within Texas. These E&E assets will be transferred to property and equipment when technological feasibility and commercial viability have been established. During the year ended December 31, 2014 indicators of impairment were identified and an impairment test was completed (see note 9). Impairment of \$156,768 was recognized in the year.

### 9 Impairment loss

As at December 31, 2014, the Company reviewed its oil and gas assets for indicators of impairment such as changes in future prices, future costs and reserves. Based on this review, certain of the Company's CGUs were tested for impairment. The recoverable amount of each CGU was estimated based on the higher of the value in use and the FVLCTS. The estimate of FVLCTS was determined using a discount rate of 15% and forecasted cash flows, with escalating prices and future development costs, as obtained from the reserve report. The prices used to estimate the FVLCTS are those used by independent industry reserve engineers.

# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

In light of a decline in natural gas prices, impairment tests were conducted at December 31, 2014 on the Company's oil and gas properties CGUs. The estimated recoverable amounts were determined using fair value less cost to sell.

In determining the recoverability of gas interests and making these evaluations, the Company used the net present value of the cash flows from the proved plus probable reserves of oil and gas properties CGU as estimated by the Company's independent reserve evaluator.

Key input estimates used in the determination of cash flows from the oil and gas reserves include the following:

- a) Reserves – Assumptions that are valid at the time of reserve estimation may change significantly when new information becomes available. Changes in forward price estimates, production costs or recovery rates may change the economic status of reserves and may ultimately result in reserves being restated.
- b) Crude oil and natural gas prices – Forward price estimates of the crude oil and natural gas prices are used in the cash flow model. Commodity prices have fluctuated widely in recent years due to global and regional factors including supply and demand fundamentals, inventory levels, exchange rates, weather, economic and geopolitical factors.
- c) Discount rate – The discount rate used to calculate the net present value of cash flows is 15% post tax.

Below are the following forward commodity price estimates used in the December 31, 2014 impairment test:

|      | Natural gas<br>(AECO)<br>Cdn \$ / mmbtu | Crude oil<br>(Edmonton Par)<br>Cdn \$ / bbl |
|------|---|---|
| 2015 | 3.96                                    | 68.58                                       |
| 2016 | 4.53                                    | 80.07                                       |
| 2017 | 4.81                                    | 85.74                                       |
| 2018 | 5.09                                    | 91.41                                       |
| 2019 | 5.37                                    | 97.07                                       |
| 2020 | 5.65                                    | 102.74                                      |
| 2021 | 5.93                                    | 104.79                                      |
| 2022 | 6.05                                    | 106.89                                      |
| 2023 | 6.16                                    | 109.02                                      |
| 2024 | 6.27                                    | 111.21                                      |

Each benchmark price increased on average approximately 2% from 2014 and thereafter

For the year ended December 31, 2014, the Company recorded an impairment of \$359,100 (December 31, 2013 - \$550,596) on its oil and gas properties CGU. The impairment was

# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

recognized because the carrying value exceeded the recoverable amount. The fair value less cost to sell values used to determine the recoverable amounts of the impaired PP&E assets are classified as Level 3 fair value measurements.

The E&E asset impairment is \$156,768 for the year ended December 31, 2014 (December 31, 2013: nil). The impairment was recognized upon a review of each exploration license or field, carried out, at least annually, to confirm whether the Company intends further appraisal activity or to otherwise extract value from the property.

### 10 Decommissioning obligations

The Company's decommissioning obligations result from its ownership interest in oil and natural gas assets including well sites and gathering systems. The total decommissioning obligation is estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities and the estimated timing of the costs to be incurred in future years. The Company has estimated the net present value of the decommissioning obligations to be \$450,604 as at December 31, 2014 (December 31, 2013 - \$559,751) based on an undiscounted total future liability of \$483,745 (December 31, 2013 - \$700,853). These payments are expected to be made over the next 2 to 24 years. The obligations have been calculated using an inflation rate of 2% and a discount factor, being the risk-free rate related to the liability, of 1.01% - 2.33% (December 31, 2012 - 2% and 1.68% - 2.77%, respectively).

|                                   | December 31, 2014 | December 31, 2013 |
|-----------------------------------|-------------------|-------------------|
|                                   | \$                | \$                |
| <b>Balance, beginning of year</b> | <b>559,751</b>    | 182,180           |
| Disposals                         | <b>(14,094)</b>   | (42,344)          |
| Liabilities incurred              |                   | 35,124            |
| Abandonments                      | <b>(92,767)</b>   | -                 |
| Revisions (changes in estimates)  | <b>40,032</b>     | 381,945           |
| Accretion                         | <b>17,682</b>     | 2,846             |
| <b>Balance, end of year</b>       | <b>510,604</b>    | 559,751           |

During the year ended December 31, 2014, the Orphan Well Society abandoned and reclaimed certain wells owned by the Company. The costs incurred by the Orphan Well Society of \$92,767 to abandon and reclaim the wells have been recorded as a gain in the Company's statement of loss and comprehensive loss.

### 11 Bank loan

On July 10, 2014, the Company and its joint venture partners ("Partners") on the Electric Generation Pilot Project ("Project") entered into a loan agreement (the "Loan") with a Canadian Chartered Bank (the "Lender") in the amount of \$500,000, of which the Company is liable for

# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

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\$42,500. The proceeds of the Loan were used towards the purchase of equipment utilized in the Project. The Loan matures on June 14, 2017 and bears interest of 5.75% per annum, calculated daily, compounded and payable monthly. Principal repayments are required monthly until maturity. At December 31, 2014, the Company's portion of principal repayments and interest payments were \$5,498 and \$972 respectively, and the outstanding balance is \$37,002. The Loan is secured against certain assets as collateral of the Company and Partners.

### 12 Loan

On June 15, 2012, a corporation owned by a party who has a common significant shareholding (the "Lender") advanced \$1,500,000 to the Company under a loan agreement (the "Original Loan Agreement") with a maturity date of August 15, 2013. Interest on the loan is 10% per annum, payable monthly, on the outstanding principal amount. On August 15, 2013, the Original Loan with an outstanding balance of \$1,200,000 was cancelled, and a new loan in the amount of \$1,200,000 was issued with a maturity date of August 15, 2014 (the "New Loan"), with all terms and conditions remaining the same. Included in the New Loan was a conversion feature, which at the option of the Lender, and subject to regulatory approval, the entire principal amount of the New Loan, or any portion outstanding, may have been converted to shares in the Company at a price of \$0.05 per common share until August 15, 2014. The conversion feature on the New Loan did not receive regulatory approval prior to expiration.

The Company may, at any time, repay the New Loan in full without notice or penalty. If the Company is in default of the requirements included in the New Loan agreement or the Lender believes the Company's ability to repay the loan is impaired, the Lender may demand repayment of the New Loan or accelerate the date for payment. During the year ended December 31, 2014, the Company incurred interest of \$127,754 (December 31, 2013 - \$120,000).

Pursuant to the Original Loan Agreement, the Company issued to the Lender 5,000,000 share purchase warrants (the "Original Warrants"). The Original Warrants were valued at \$147,195 and were treated as a transaction cost, and were netted against the principal balance of the loan, which was accreted back up to the principal balance at the maturity date. The accretion of the Original Warrants was recorded as a non-cash finance expense in the consolidated statement of comprehensive loss. On August 15, 2013, the Original Warrants expired unexercised. Pursuant to the New Loan agreement, the Company issued to the Lender 5,000,000 share purchase warrants (the "New Warrants"). Each New Warrant is exercisable into one common share of the Company at a price of \$0.05 per common share until the expiry date of August 15, 2014. On April 9, 2014, the New Warrants received regulatory approval and accordingly were valued as of this date at \$40,241 and treated consistently with the Original Warrants. On August 15, 2014, the New Warrants expired unexercised.

# **Emerald Bay Energy Inc.**

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

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On October 2, 2014, the Company received approval to extend the maturity date of the New Loan until August 15, 2015, with a 10% interest rate that compounds monthly (the “Extension”). Pursuant to the Extension, no warrants were offered, however a conversion feature enabling the Lender to convert any or all of the outstanding Extension into common shares of the Company at a conversion price of \$0.05 per common share at any time prior to the August 15, 2015, subject to regulatory approval. As at December 31, 2014, the conversion feature on the Extension had not yet receive regulatory approval and accordingly no value has been assigned to this feature. All other terms and conditions of the Extension remain unchanged.

During the year ended December 31, 2014, the Lender advanced an additional \$100,000 to the Company under the same terms as the New Loan. However, the additional advance was not included in the conversion feature.

The following table summarizes the accounting of the Loan:

|                                   | Loan<br>\$       | Total<br>\$      |
|-----------------------------------|------------------|------------------|
| <b>Balance, December 31, 2012</b> | <b>1,121,565</b> | <b>1,121,565</b> |
| Accretion of transaction cost     | 78,435           | 78,435           |
| <b>Balance, December 31, 2013</b> | <b>1,200,000</b> | <b>1,200,000</b> |
| Receipt of additional funds       | 100,000          | 100,000          |
| Transaction costs                 | (93,710)         | (93,710)         |
| Accretion of transaction costs    | 93,710           | 93,710           |
| <b>Balance, December 31, 2014</b> | <b>1,300,000</b> | <b>1,300,000</b> |

Security for the New Loan consists of a \$1,200,000 promissory note plus interest at the rate of 10% per annum, compounded monthly, a General Security Agreement in favour of the Lender to include a specific assignment of production proceeds, and security over the US assets of the Company. The Lender has required the Company to submit to them certain reports including monthly production reports.

# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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### **13 Convertible debt**

On January 1, 2012, the Company entered into a loan agreement (the "Loan Agreement") with a corporation owned and controlled by a party who is also a significant shareholder of the Company (the "Lender") whereby the Company received a \$150,000 USD loan with a maturity date of one year. Pursuant to the Loan Agreement, if it is mutually agreed upon by both parties, the maturity date can be extended by an additional year. On January 1, 2013 and January 1, 2014, it was mutually agreed upon between the Lender and the Company to extend the loan under the same terms for an additional year. Interest on the loan is 12% per annum, payable monthly, on the outstanding principal amount monthly. During the year ended December 31, 2014, the Company incurred interest of \$29,486 (December 31, 2013 - \$19,726).

Security for the loan consists of a \$150,000 promissory note and monthly production from certain Texas assets equivalent to the principal portion of the loan and any unpaid interest.

At the option of the Lender, and subject to regulatory approval, the entire principal amount, or any portion outstanding, may be converted to shares in the Company with a discount of 25% to the market trading price at the time of conversion, at any time during the term. Accordingly, on the issuance and extension, the loan is split between the liability and the conversion feature, which is recorded on the statement of financial position as a derivative financial liability. The liability portion is determined by subtracting the fair value of the conversion feature from the principal amount of the loan. The fair value of the conversion feature is estimated at every statement of financial position date with changes in the fair value estimate between periods recognized in the consolidated statement of comprehensive loss as finance expense. The liability portion is measured at amortized cost and is accreted up to the principal balance at the maturity date. The accretion is expensed as a finance expense in the consolidated statement of comprehensive loss as finance expense. Any accrued interest thereon may also be converted in to common shares, in accordance with the regulatory policies. At January 1, 2013, the \$150,000 loan resulted in \$20,000 being classified as a liability and \$130,000 being classified as a derivative financial liability.

At December 31, 2013, the loan had matured and the initial derivative liability that was recognized was removed and recorded as a gain on the derecognition of the derivative financial liability in the consolidated statement of comprehensive loss as finance expense. On the January 1, 2014 extension, the terms of the conversion feature were changed to establish the conversion price to be \$0.05 per common share, and accordingly, \$72,572 of the principal amount of the loan was classified as a derivative financial liability. All other terms and conditions remain the same.

# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

During the year ended December 31, 2014, the Lender advanced an additional loan amount of \$100,000 USD to the Company under the same terms as the Loan Agreement. However, the additional advance was not included in the conversion feature. The proceeds of the loan were used to continue the Company's exploration program in Texas.

The following table summarizes the accounting of the promissory note in USD:

|  | Liability<br>\$ | Derivative Financial Liability<br>\$ | Total<br>\$    |
|--|-----------------|--------------------------------------|----------------|
| <b>Balance, at December 31, 2012</b>     | 150,000         | -                                    | 150,000        |
| Renewal of debt                          | (130,000)       | 130,000                              | -              |
| Accretion of debt                        | 130,000         | -                                    | 130,000        |
| (Gain) on derivative financial liability | -               | (130,000)                            | (130,000)      |
| <b>Balance, December 31, 2013</b>        | <b>150,000</b>  | -                                    | <b>150,000</b> |
| Receipt of additional funds              | 100,000         | -                                    | 100,000        |
| Derivative financial liability           | (72,572)        | 72,572                               | -              |
| Accretion of debt                        | 72,572          | -                                    | 72,572         |
| (Gain) on derivative financial liability | -               | (72,572)                             | (72,572)       |
| <b>Balance, December 31, 2014</b>        | <b>250,000</b>  | -                                    | <b>250,000</b> |

The fair value of the derivative financial liability was determined using the Black-Scholes valuation model and the following assumptions were used:

|                         | June 30, 2014 | January 1, 2013 |
|-------------------------|---------------|-----------------|
| Risk-free interest rate | 1.09%         | 1.17%           |
| Expected life (years)   | 0.5 years     | 1 year          |
| Expected volatility     | 234.82%       | 165.11%         |
| Market price            | 0.04          | 0.04            |
| Conversion price        | 0.05          | 0.03            |

On March 26, 2015, it was mutually agreed upon between the Lender and the Company to extend the loan under the same terms to December 31, 2015. The modification did not result in an extinguishment of the old convertible debt instrument and recognition of a new convertible debt instrument.

# Emerald Bay Energy Inc.

Notes to the Consolidated Financial Statements  
For the years ended December 31, 2014 and 2013

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## 14 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<br>Shares | Amount<br>\$ |
|---|----------------------------|--------------|
| <b>Balance, December 31, 2012</b>                           | 132,721,689                | 9,806,332    |
| expiry of warrants (note 14(c))                             | -                          | 574,096      |
| Private placement (i)                                       | 7,950,000                  | 397,500      |
| Value of warrants issued pursuant to private placement (i)  | -                          | (141,188)    |
| Share issue costs (i)                                       | -                          | (35,516)     |
| <b>Balance, December 31, 2013</b>                           | 140,671,689                | 10,601,224   |
| expiry of warrants (note 14(c))                             | -                          | 809,550      |
| Issue costs for expired warrants                            |                            | (134,493)    |
| Private placement (ii)                                      | 16,938,500                 | 896,925      |
| Share subscription receivable                               |                            | (50,000)     |
| Value of warrants issued pursuant to private placement (ii) | -                          | (759,435)    |
| Share issue costs (ii)                                      | -                          | (22,508)     |
| <b>Balance, December 31, 2014</b>                           | 157,610,189                | 11,341,263   |

- (i) On April 3, 2013, the Company completed a private placement (“Placement A”), issuing 7,950,000 units. Each unit under Placement A was issued at \$0.05 for total proceeds of \$397,500. Each unit consists of one common share of the Company and one share purchase warrant (“Warrant A”). Each Warrant A entitles the holder to purchase one additional common share of the Company at \$0.10 per share, exercisable for 1 year from the original issue date. The Company has allocated \$141,188 of the unit value to warrants (note 14(c)).

Pursuant to Placement A, the Company incurred \$38,259 in cash share issue costs, of which \$24,672 was allocated to share capital and \$13,587 was allocated to warrants. 645,000 finders options were issued, respectively, valued at \$16,818 (note 14(e)), of which \$10,844 was allocated to share capital and \$5,974 was allocated to warrants.

- (ii) On September 3, 2014, the Company completed a private placement (“Placement B”), issuing 17,938,500 units. Each unit under Placement B was issued at \$0.05 for total proceeds of \$896,925. Each unit consists of one common share of the Company and one share purchase warrant (“Warrant B”). Each Warrant B entitles the holder to purchase one additional common share of the Company at \$0.05 per share, exercisable for 1 year from the original issue date. The Company has allocated \$759,436 of the unit value to



# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

warrants (note 14(c)). Of the total units under issue by the Company, proceeds for 1,000,000 units were not received by the Company and have therefore been excluded.

Pursuant to Placement B, the Company incurred \$88,175 in cash share issue costs, of which \$13,517 was allocated to share capital and \$74,657 was allocated to warrants. 1,385,500 finders options were issued, respectively, valued at \$58,656 (note 14(e)), of which \$8,991 was allocated to share capital and \$49,665 was allocated to warrants.

### c) Warrants

Warrants to acquire common shares outstanding at December 31, 2014 are as follows:

|   | Number of<br>warrants issued<br>and exercisable | Amount<br>\$ | Weighted average<br>exercise price<br>\$ | Weighted average<br>Remaining life<br>(years) |
|---|---|--------------|--|---|
| <b>Balance, December 31, 2012</b>                                       | 59,995,730                                      | 1,274,721    | 0.10                                     | 0.06  |
| Expiry of share purchase warrants                                       | (25,315,730)                                    | (574,096)    | 0.10                                     | -   |
| Expiry of share purchase warrants (note 8)                              | (5,000,000)                                     | (147,195)    | 0.10                                     | -   |
| Share purchase warrants issued (note 14(b)(i))                          | 7,950,000                                       | 141,188      | 0.10                                     | 0.06  |
| Share issue costs (note 14(b)(i))                                       | -   | (19,561)     | -  | -   |
| <b>Balance, December 31, 2013</b>                                       | 37,630,000                                      | 675,057      | 0.10                                     | 0.06  |
| Expiry of share purchase warrants                                       | (37,630,000)                                    | (809,550)    | -  | -   |
| Share purchase warrants issued (note 14(b)(ii))                         | 17,938,500                                      | 759,435      | 0.05                                     | 0.63  |
| Share issue costs (note 14(b)(ii))                                      | -   | (124,322)    | -  | -   |
| Share purchase warrants issued pursuant to the Loan (note 12)           | 5,000,000                                       | 40,241       | 0.05                                     | -   |
| Expiry of share purchase warrants issued pursuant to the Loan (note 12) | (5,000,000)                                     | (40,241)     | -  | -   |
| <b>Balance, December 31, 2014</b>                                       | 17,938,500                                      | 635,113      | 0.05                                     | 0.63  |

The fair value of the share purchase warrants granted during the year are estimated at the grant date using the Black-Scholes option pricing model and have been credited to warrants within shareholders' equity. A weighted average of the assumptions used in the calculation is noted below:

|                        | 2014       | 2013       |
|------------------------|------------|------------|
| Risk-free rate         | 1.09%      | 1.01%      |
| Expected life          | 1 year     | 1.00 years |
| Expected volatility    | 281.90%    | 140.95%    |
| Fair value per warrant | \$0.040572 | \$0.018    |

Volatility was determined based on the Company's historical share prices.

# Emerald Bay Energy Inc.

Notes to the Consolidated Financial Statements  
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## d) Stock options

The Company established a share option plan (the "Plan") 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 the Company. The term, the vesting period and the exercise price are determined at the discretion of the Board of Directors. However, the maximum option term shall not exceed five years.

During the year ended December 31, 2014, there were no stock options granted, cancelled, exercised or stock options that expired unexercised. The following table summarizes information about the Company's stock options outstanding at December 31, 2014:

|   | December 31, 2014 |                                    | December 31, 2013 |                                    |
|---|-------------------|------------------------------------|-------------------|------------------------------------|
|   | Number of options | Weighted Average Exercise price \$ | Number of options | Weighted Average Exercise price \$ |
| <b>Stock options, beginning of year</b>       | <b>14,030,000</b> | <b>0.08</b>                        | 7,380,000         | 0.10                               |
| Granted                                       | -                 | -                                  | 6,700,000         | 0.05                               |
| Cancelled                                     | -                 | -                                  | (50,000)          | 0.10                               |
| <b>Stock options outstanding, end of year</b> | <b>14,030,000</b> | <b>0.08</b>                        | 14,030,000        | 0.08                               |

The total stock options outstanding at December 31, 2014 are as follows:

| Exercise prices (\$) | Options outstanding | Weighted average remaining term (years) | Weighted average exercise price (\$) |
|----------------------|---------------------|---|--------------------------------------|
| 0.05                 | 6,700,000           | 3.80                                    | 0.05                                 |
| 0.10                 | 7,330,000           | 1.19                                    | 0.10                                 |

As at December 31, 2014, all stock options have vested and are exercisable.

# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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The terms of the granted stock options are consistent with the Plan and are all exercisable at \$0.10 per option and expire 5 years after the grant date. The fair value of the options granted is estimated as at the grant date using the Black-Scholes option pricing model. The weighted average assumptions used in the calculation are noted below:

|                         | <u>2013</u>    |
|-------------------------|----------------|
| Risk-free interest rate | <b>1.66%</b>   |
| Expected life           | <b>5 years</b> |
| Expected volatility     | <b>389.29%</b> |
| Fair value per option   | <b>\$0.04</b>  |
| Forfeiture rate         | <b>9.23%</b>   |
| Dividend                | -              |

During the year ended December 31, 2014, the Company recognized share-based payment expense of \$7,397 in the statement of comprehensive loss (December 31, 2013 - \$219,964). Volatility was determined based on the Company's historical share prices.

### **e) Finders options**

During the year ended December 31, 2014, the Company issued 1,385,500 Finders Options ("Finders Options B), respectively, to the those who facilitated Placement B (note 14(b)(ii)). Each Finders Options B is exercisable into one unit consisting of one common share and one common share purchase warrant ("Finder Warrant B") of the Company at \$0.05 per unit. Each Finder Warrant B is exercisable into one common share of the Company at \$0.05 per common share. The Finders Options B expire one year from the original grant date. The Finders Options B were valued at \$58,656 (note 14(b)(ii)). The warrant embedded within the Finders Options B were not separately valued.

During the year ended December 31, 2013, the Company issued 645,000 Finders Options, respectively, to the those who facilitated Placement A (note 14(b)(i)). Each Finders Option was exercisable into one unit consisting of one common share and one common share purchase warrant ("Finder Warrant") of the Company at \$0.05 per unit. Each Finder Warrant was exercisable into one common share of the Company at \$0.10 per common share. The Finders Options expired one year from the original grant date. The Finders Options were valued at \$16,818 (note 14(b)(i)). The warrant embedded within the Finders Options were not separately valued.

# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

The following table summarizes information about the Company's Finder Options outstanding at December 31, 2014:

|   | December 31, 2014 |                                    | December 31, 2013 |                                    |
|---|-------------------|------------------------------------|-------------------|------------------------------------|
|   | Number of options | Weighted Average Exercise price \$ | Number of options | Weighted Average Exercise price \$ |
| <b>Finders Options, beginning of year</b>       | <b>645,000</b>    | <b>0.05</b>                        | 3,113,000         | 0.05                               |
| Granted (note 11(b)(ii))                        | <b>1,385,500</b>  | <b>0.05</b>                        | 645,000           | 0.05                               |
| Expired   | <b>(645,000)</b>  | <b>(0.05)</b>                      | (3,113,000)       | (0.05)                             |
| <b>Finders Options outstanding, end of year</b> | <b>1,385,500</b>  | <b>0.05</b>                        | 645,000           | 0.05                               |

The Finders Options B were valued at an aggregate of \$58,656 (note 14(b)(ii)). The fair value of the Finders Options granted were estimated as at the grant date using the Black-Scholes option pricing model. The assumptions used in the calculation are noted below:

|                         | 2014           | 2013    |
|-------------------------|----------------|---------|
| Risk-free interest rate | <b>1.01%</b>   | 1.01%   |
| Expected life           | <b>1 year</b>  | 1 year  |
| Expected volatility     | <b>282.05%</b> | 140.95% |
| Fair value per option   | <b>\$0.04</b>  | 0.03    |

Volatility was determined based on the Company's historical share prices.

### f) Contributed surplus

|   | December 31, 2014 | December 31, 2013 |
|---|-------------------|-------------------|
|   | \$                | \$                |
| <b>Balance, beginning of year</b>             | <b>1,664,311</b>  | 1,135,960         |
| Share-based payment expense                   | <b>7,397</b>      | 219,694           |
| Finders options (note 14(b)(iv and v))        | <b>58,656</b>     | 16,817            |
| Expiry of share purchase warrants (note 12)   | <b>93,710</b>     | 147,195           |
| Gain on sale of property to equity investment | -                 | 144,375           |
| <b>Balance, end of year</b>                   | <b>1,824,074</b>  | 1,664,311         |

### g) Per share data

Basic earnings per share are calculated based on the weighted average number of shares outstanding during the year. 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 year.

# **Emerald Bay Energy Inc.**

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

All warrants, finders options and stock options have been excluded from the calculation of diluted shares outstanding as they would be anti-dilutive due to the loss position of the Company.

### **15 Income tax**

Income tax expense differs from that which would be expected from applying the combined effective Canadian federal and provincial corporate tax rates of 25.00% (December 31, 2013 – 25.00%) to income before income taxes as follows:

|   | <b>December 31, 2014</b> | December 31, 2013 |
|---|--------------------------|-------------------|
|   | \$                       | \$                |
| Loss per statement of comprehensive loss    | <b>(1,491,385)</b>       | (2,150,789)       |
| Tax rate                                    | <b>25.00%</b>            | 25.00%            |
| Expected income tax provision               | <b>(372,846)</b>         | (537,697)         |
| Increase (decrease) resulting from:         |                          |                   |
| Share-based payments                        | <b>1,849</b>             | 54,991            |
| Equity investments                          | <b>5,806</b>             | 2,465             |
| Other                                       | <b>12,324</b>            | 7,278             |
| Non deductible expenses                     | <b>(25,413)</b>          | 21,760            |
| ACRI expired                                | -                        | 110,080           |
| Change in deferred tax asset not recognized | <b>390,605</b>           | 341,123           |
|   | <b>-</b>                 | -                 |

Significant components of the deferred taxes are as follows:

|  | <b>December 31, 2014</b> | December 31, 2013 |
|--|--------------------------|-------------------|
|  | \$                       | \$                |
| Property and equipment                           | <b>659,265</b>           | 438,484           |
| Non-capital loss carried forward                 | <b>1,891,372</b>         | 1,696,446         |
| Decommissioning liabilities                      | <b>119,193</b>           | 139,938           |
| Share issue costs                                | <b>42,809</b>            | 41,505            |
| Equity investments                               | <b>(8,409)</b>           | (14,215)          |
| Flow-through share indemnity liability           | <b>83,388</b>            | 83,388            |
| Scientific research and experimental development | <b>150,663</b>           | 150,663           |
| Financing fees                                   | <b>22,933</b>            | 34,400            |
| Investment tax credits                           | <b>195,000</b>           | 195,000           |
| Deferred tax asset not recognized                | <b>3,156,214</b>         | 2,765,609         |

# **Emerald Bay Energy Inc.**

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The Company has estimated tax pools totaling:

|  | <b>Rate of Claim</b> | <b>December 31, 2014</b> |
|--|----------------------|--------------------------|
|  |                      | <b>\$</b>                |
| Canadian exploration expenditures                | 100%                 | <b>1,676,124</b>         |
| Canadian oil and gas property expense            | 30%                  | <b>34,811</b>            |
| Foreign development expenditures                 | Various              | <b>1,266,597</b>         |
| Undepreciated capital cost                       | Various              | <b>1,400,617</b>         |
| Share issue costs                                | 20%                  | <b>171,237</b>           |
| Financing fee                                    | 20%                  | <b>91,733</b>            |
| Scientific research and experimental development |                      | <b>602,650</b>           |
| Attributed Canadian royalty income               |                      | <b>780,000</b>           |
| Non-capital loss carry forward                   |                      | <b>7,565,489</b>         |
|  |                      | <b>13,886,511</b>        |

The accumulated non-capital loss carry forwards expire as follows:

|      |                     |
|------|---------------------|
| 2034 | 154,333             |
| 2033 | 1,187,782           |
| 2032 | 1,275,386           |
| 2031 | 737,023             |
| 2030 | 1,258,784           |
| 2029 | 813,179             |
| 2028 | 1,207,419           |
| 2027 | 931,583             |
|      | <b>\$ 7,565,489</b> |

# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

### 16 Related party transactions

Related party transactions not disclosed elsewhere in these Consolidated Financial Statements are as follows:

a) The following amounts are due from related parties:

|                                  | December 31, 2014 | December 31, 2013 |
|----------------------------------|-------------------|-------------------|
|                                  | \$                | \$                |
| Note receivable from officer (i) | <b>247,970</b>    | 244,719           |
| Fair value allowance (ii)        | -                 | (240,789)         |
| Net note receivable              | <b>247,970</b>    | 3,930             |
| Advance fees (iii)               | -                 | 6,529             |
|                                  | <b>247,970</b>    | 10,459            |
| Less current portion             | <b>(50,000)</b>   | (10,459)          |
|                                  | <b>197,970</b>    | -                 |

- (i) During the year ended December 31, 1999, a promissory note was issued to an officer of the Company bearing interest at 3% per annum with no fixed maturity date, unless the officer's employment is terminated or he is petitioned into bankruptcy wherein the note and accrued interest becomes immediately payable. During the year ended December 31, 2014, the Company revised the terms of the loan (the "Revised Promissory Note"), including fixed repayment terms and removing the term securing the note with 393,000 common shares of the Company. Historically the aggregate decline in the fair value of these common shares since the inception of the promissory note would offset the amount payable (December 31, 2013 – fair value allowance \$240,789). Under the Revised Promissory Note, a balance of \$247,970, including the principal of \$218,500 and accrued interest, is payable by the officer to the Company. The payments will commence December 31, 2015, and will be paid annually in \$50,000 tranches until December 31, 2018, with the final payment of \$47,970 due on December 31, 2019. Interest is calculated at 1% per annum, and is payable annually commencing December 31, 2015, concurrently with each principal payment. The officer may repay the principal amount in whole or in part at any time. The reversal of the fair value allowance of \$237,511 was included in the statement of loss and comprehensive loss.
- (ii) The fair value allowance was initially determined on December 31, 2008 based on the market value of the secured shares. During the year ended December 31, 2013, an additional allowance of \$24,274 was made as the carrying value of the promissory note exceeded the fair value of the 393,000 common shares held as security.

# **Emerald Bay Energy Inc.**

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

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- (iii) During the year ended December 31, 2008, a director was advanced \$59,473 in relation to efforts to finance and advance the Company's drilling technology. At December 31, 2014 \$Nil (December 31, 2013 - \$6,529) the amount remaining outstanding was determined to be uncollected and was included in bad debt recovery on the statement of loss and comprehensive loss.
- b) Additional related party transactions not disclosed elsewhere in these Consolidated Financial Statements are as follows:
- (i) Aggregate fees of \$1,192 (December 31, 2013 - \$3,150) were charged by directors of the Company all of which was recorded in the statement of comprehensive loss.
- (ii) Aggregate fees of \$nil (December 31, 2013 - \$44,000) were charged by a U.S. corporation, which is owned and controlled by an officer and a director of the Company for costs it incurred for operation of the Company's U.S. properties, all of which was recorded in the statement of comprehensive loss.
- (iii) Aggregate fees of \$34,465 (December 31, 2013 - \$34,465) were charged by corporations, which are owned and controlled by other equity investors in PRI, and were all recorded as general and administrative costs.
- (iv) Included in accounts payable at December 31, 2014 was \$104,611 owing to officers of the Company (December 31, 2013 - \$120,574).
- (v) Aggregate fees of \$nil (December 31, 2013 - \$10,000) were charged by an officer of the Company during the year for consulting work completed on the Companies research and development program.
- (vi) Included in general and administrative costs is \$nil (December 31, 2013 - \$10,000) of rent expense charged by an officer of the Company for office rent.

### *Key management compensation*

|                      | December 31, 2014 | December 31, 2013 |
|----------------------|-------------------|-------------------|
|                      | \$                | \$                |
| Compensation         | <u>452,740</u>    | 426,400           |
| Share based payments | -                 | 219,964           |
| Total                | <u>452,740</u>    | <u>646,364</u>    |



# **Emerald Bay Energy Inc.**

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

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### **17 Commitments**

- a) On January 15, 2012, the Company entered into a lease agreement with a related party for the lease of office space. Under a lease agreement, the Company has committed to monthly payments of \$2,771 for the lease of its office space until January 31, 2015.
- b) The Company has entered into various vehicle loan agreements and as at December 31, 2014, total annual principal repayments of \$14,988 remain, all of which will be paid in the year ending December 31, 2015.
- c) The Company raised capital through the issuance of flow through shares in 2009, 2010 and 2011 which provided indemnity to the subscriber for additional taxes payable if the Company was unable to, or failed to, renounce the qualifying expenditures as agreed. The Company was not able to spend \$824,338 of the flow through funds raised. The Company is exposed to costs for the indemnification of the subscribers. The Company has estimated a potential liability on the amount of \$333,551 at December 31, 2014 (December 31, 2013 - \$333,551). The Company has also estimated a potential liability for penalties and taxes on the amounts of \$107,500 (December 31, 2013 - \$66,735) and is included in accounts payable and accrued liabilities. The accrued amount is subject to measurement uncertainty due to the tax filing positions of the subscribers, their tax rates and the amount of personal taxes that may be payable and the interpretation of the indemnity agreement, which will not be known until potentially affected subscribers are reassessed for their tax positions by the Canada Revenue Agency and these amounts become known to the Company.

### **18 Supplemental cash flow information**

|  | <b>December 31, 2014</b> | December 31, 2013 |
|--|--------------------------|-------------------|
|  | \$                       | \$                |
| The Company had the following non-cash transactions. |                          |                   |
| Fair value of finders options (note 14(e))           | <b>58,656</b>            | 16,818            |
| Gain (loss) on disposal of property                  | <b>42,380</b>            | 144,375           |
| Change in estimates in decommissioning liabilities   | <b>41,389</b>            | 381,945           |
| Cash interest paid                                   | <b>158,113</b>           | 142,839           |

# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

### 19 Financial risk management

The Board of Directors oversees managements' establishment and execution of the Company's risk management framework. Management has implemented and monitors compliance with risk management policies. The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities.

#### (a) Fair values

The Company's financial instruments consist of cash and cash equivalents, short-term investments, trade and other receivables, due from related parties, accounts payable and accrued liabilities, the shareholder indemnity, the loan, the convertible debt, the bank loan, current portion of long-term debt and long-term debt.

| <b>Financial Instrument</b>              | <b>Classification</b>              | <b>Carrying Value</b> | <b>Fair Value</b> |
|--|------------------------------------|-----------------------|-------------------|
|  |                                    | <b>\$</b>             | <b>\$</b>         |
| Cash and cash equivalents                | Fair value through profit and loss | 169,556               | 169,556           |
| Short-term investments                   | Fair value through profit and loss | 59,178                | 59,178            |
| Trade and other receivables              | Loans and receivables              | 241,924               | 241,924           |
| Due from related parties                 | Loans and receivables              | 247,970               | 247,970           |
| Accounts payable and accrued liabilities | Other financial liabilities        | 4,016,905             | 4,016,905         |
| Shareholder indemnity                    | Other financial liabilities        | 333,551               | 333,551           |
| Loan                                     | Other financial liabilities        | 1,300,000             | 1,300,000         |
| Convertible debt                         | Other financial liabilities        | 290,025               | 290,025           |
| Bank loan                                | Other financial liabilities        | 37,002                | 37,002            |
| Current portion of long-term debt        | Other financial liabilities        | 14,988                | 14,988            |

The significance of inputs used in making fair value measurements are examined and classified according to a fair value hierarchy. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly. Level 3 valuations are based on inputs that are unobservable and significant to the overall fair value measurement.

At December 31, 2014, the Company's cash and cash equivalents and short-term investments have been subject to Level 1 valuation.

#### (b) Credit risk:

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint venture partners and oil and natural gas marketers.

# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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Virtually all of the Company's trade and other receivables are from companies in the oil and gas industry and are subject to normal industry credit risks. Credit risks arise principally from the amounts owing to the Company from oil and natural gas marketers and joint venture partners. Management does not believe that any significant concentration of trade and other receivables exists that will result in any loss to the Company based on past payment experience. Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish relationships with large marketers. However, the receivables are from participants in the petroleum and natural gas sector and collection of the outstanding balances is dependent on industry factors such as commodity price fluctuations and escalating costs. The Company does not typically obtain collateral from petroleum and natural gas marketers or others in the event of non-payment.

At December 31, 2014, the Company's trade and other receivables have been aged as follows:

|                         | <b>December 31, 2014</b> | December 31, 2013 |
|-------------------------|--------------------------|-------------------|
| <b>Days outstanding</b> | <b>\$</b>                | <b>\$</b>         |
| 0-30 days               | <b>59,609</b>            | 67,653            |
| 31-60 days              | <b>32,816</b>            | 6,204             |
| 61-90 days              | <b>36,418</b>            | 56,561            |
| Greater than 90 days    | <b>113,081</b>           | 330,669           |
| Total                   | <b>241,924</b>           | 461,087           |

Amounts outstanding for more than 90 days are considered past due. During the year ended December 31, 2014, the Company wrote off \$43,064 of trade and other receivables. The Company deems all amounts remaining in trade and other receivables as collectible and as such, a provision for doubtful accounts has not been recorded at December 31, 2014 (December 31, 2013 - \$nil).

Cash and cash equivalents consist of cash bank balances held in both interest and non-interest bearing accounts. The Company manages credit exposure of cash by selecting financial institutions with high credit ratings.

# **Emerald Bay Energy Inc.**

## **Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013**

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### (c) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. At December 31, 2014, the Company's maximum exposure to liquidity risk is the total current liabilities of \$5,955,469 (December 31, 2013 - \$5,183,119).

The current liabilities and commitments are due as follows:

|  |           |                                    |
|--|-----------|------------------------------------|
| Accounts payable and accrued liabilities       | 4,016,905 | Due within 90 days                 |
| Loan (note 12)                                 | 1,300,000 | Maturity date of August 15, 2013   |
| Convertible debt (note 13)                     | 290,025   | Maturity date of December 31, 2013 |
| Current portion of long-term debt (note 17(b)) | 14,988    | Due within 12 months               |
| Shareholder indemnities (note 17(c))           | 333,551   | Due on demand                      |

The Company has entered into lease agreements on office premises for its various locations. Future minimum annual lease payments under the lease agreement are as follows:

|      |          |
|------|----------|
| 2016 | \$33,247 |
|------|----------|

The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Company's reputation.

To achieve this objective, the Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non operated projects to further manage capital expenditures. The Company also attempts to match its payment cycle with collection of oil and natural gas revenue on the 25th of each month.

### (d) Market risk

Market risk is the risk that changes in market prices, such as commodity prices, foreign exchange rates and interest rates will affect the Company's loss or the value of the financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while maximizing returns.

# **Emerald Bay Energy Inc.**

Notes to the Consolidated Financial Statements  
For the years ended December 31, 2014 and 2013

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(i) Commodity price risk:

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for oil and natural gas are impacted by not only the relationship between the Canadian and United States dollar but also world economic events that dictate the levels of supply and demand. All of the Company's oil and gas production is sold at spot rates exposing the Company to the risk of price movements.

The Company had no commodity call options outstanding as at December 31, 2014.

(ii) 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, trade and other receivables and accounts payable and accrued liabilities. As at December 31, 2014, an increase or decrease 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 would have had approximately a \$16,000 impact on the Company's comprehensive loss for the year.

(iii) Interest rate risk:

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. As at December 31, 2014, all of the Company's debt, including the the loan, the convertible debt and the bank loan, bears fixed interest rates and accordingly, is not subject to market interest rate fluctuations.

The Company has no interest rate swaps or financial contracts in place as at or during the year ended December 31, 2014.

(e) Capital management

The Company's capital consists of shareholders' deficit, the loan, the convertible debt and working capital. The Company will adjust its capital structure to manage its current and future

# Emerald Bay Energy Inc.

## Notes to the Consolidated Financial Statements For the years ended December 31, 2014 and 2013

debt, drilling programs and potential corporate acquisitions through the issuance of shares, sourcing additional debt financing 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 is not subject to any external capital requirements.

Management reviews its capital management approach on an ongoing basis and believes its current approach is reasonable given the size of the Company. There has been no change in management's approach to capital management during the year.

### 20 Segmented information

The Company's primary operations are limited to a single industry being the acquisition, exploration for, and development of petroleum and natural gas.

Product segmentation is as follows:

|                        | Oil     | Natural Gas | NGL's | Electricity | Total   |
|------------------------|---------|-------------|-------|-------------|---------|
| December 31, 2014 (\$) | 17,110  | 55,249      | 161   | 2,291       | 74,811  |
| December 31, 2013 (\$) | 117,267 | 51,110      | 462   | -           | 168,839 |

Geographical segmentation is as follows:

|   | December 31, 2014 (\$) |               |           |
|---|------------------------|---------------|-----------|
|   | Canada                 | United States | Total     |
| Petroleum and natural gas sales           | 74,811                 | -             | 74,811    |
| Equity income (loss) on investment in PRI |                        |               |           |
| Depletion, depreciation and impairment    | 410,221                | 159,766       | 569,987   |
| Net loss                                  | 1,140,182              | 291,203       | 1,431,385 |
| Property and equipment                    | 242,081                | 11,423        | 253,504   |
| Exploration and evaluation assets         | -                      | 1,571,666     | 1,571,666 |
| Share of investment in PRI                | 148,872                | 148,872       | 297,744   |
| Total liabilities                         | 4,412,240              | 2,090,835     | 6,503,075 |

|   | December 31, 2013 (\$) |               |           |
|---|------------------------|---------------|-----------|
|   | Canada                 | United States | Total     |
| Petroleum and natural gas sales           | 59,845                 | 108,994       | 168,839   |
| Equity income (loss) on investment in PRI | (9,861)                | (9,861)       | (19,722)  |
| Depletion, depreciation and impairment    | 642,518                | 25,332        | 667,850   |
| Net loss                                  | 1,995,404              | 155,385       | 2,150,789 |
| Property and equipment                    | 452,578                | 9,632         | 462,210   |
| Exploration and evaluation assets         | -                      | 1,235,329     | 1,235,329 |
| Share of investment in PRI                | 166,339                | 166,339       | 332,678   |
| Total liabilities                         | 3,969,312              | 1,789,427     | 5,758,739 |

# **Emerald Bay Energy Inc.**

Notes to the Consolidated Financial Statements  
For the years ended December 31, 2014 and 2013

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## **21 Subsequent events**

Subsequent to the year ended December 31, 2014, the Company was advanced an additional loan amount of \$75,000 under the same terms as the Loan Agreement described in Note 12. However, the additional advance was not included in the conversion feature.

Subsequent to the year ended December 31, 2014, the Company was advanced an additional loan amount of \$75,000 USD under the same terms as the Loan Agreement described in Note 13. However, the additional advance was not included in the conversion feature.