



Emerald Bay Energy

Emerald Bay Energy Inc.

Financial Statements

For the three and six months ended

June 30, 2010

(Prepared by Management – Unaudited)

Contents

Management Responsibility	2
Financial Statements	
Balance Sheets	3
Statements of Operations and Comprehensive Loss and Deficit	4
Statements of Cash Flows	5
Notes to Financial Statements	6 - 22

Notice to the Reader

The accompanying unaudited interim financial statements of Emerald Bay Energy Inc. for the three and six months ended June 30, 2010 have been prepared by management and approved by the Board of Directors of the Company. These statements have not been reviewed by the Company's external auditors.

Approved on behalf of Emerald Bay Energy Inc.,

(Signed) "Shelby D. Beattie"
Director

(Signed) "Gibson C. Scott"
Director

August 30, 2010
Calgary, Alberta

Emerald Bay Energy Inc.

Balance Sheet

As at June 30, 2010 and December 31, 2009

(Unaudited - expressed in Canadian dollars)

	June 30, 2010	December 31, 2009
	\$	\$
Assets		
Current Assets		
Cash	-	142,728
Short term investments	53,230	55,864
Accounts and cash call receivable	1,668,318	970,257
Prepaid expenditures	69,181	64,212
Financial contract (note 11(c))	47,379	-
	1,838,108	1,233,061
Due from related parties (note 10(a))	58,469	63,238
Property, plant and equipment (note 6)	4,963,970	5,053,833
License	5,918	11,835
Investment in Production Resources Inc (note 5)	217,107	-
	7,083,572	6,361,967
Liabilities		
Current liabilities		
Cheques in transit	112,148	-
Bank loan (note 8)	2,875,000	2,935,019
Accounts payable and accrued liabilities	3,339,244	2,616,909
Current portion of long term debt (note 13(b))	21,466	13,079
	6,347,858	5,565,007
Long term debt (note 13(b))	101,241	67,919
Asset retirement obligation (note 7)	137,055	131,757
	6,586,154	5,764,683
Shareholders' equity		
Share capital (note 9(b))	6,070,243	5,830,596
Warrants (note 9(c))	102,083	102,083
Contributed surplus (note 9(e))	876,484	766,924
Deficit	(6,551,392)	(6,102,319)
	497,418	597,284
	7,083,572	6,361,967

Nature of operations (note 1)

Commitments (note 13)

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

Emerald Bay Energy Inc.

Statement of Loss, Comprehensive Loss and Deficit For the three and six months ended June 30, 2010 and 2009

(Unaudited - expressed in Canadian dollars)

	Three months ended June 30, 2010 \$	Three months ended June 30, 2009 \$	Six months ended June 30, 2010 \$	Six months ended June 30, 2009 \$
Revenue				
Petroleum and natural gas sales	375,183	316,504	773,046	700,880
Royalties	(39,552)	(52,675)	(136,117)	(83,541)
Interest income	1,658	-	1,484	2,203
	337,289	263,829	638,413	619,542
Expenses				
Operating	175,003	187,171	319,316	302,845
General and administrative	147,164	374,616	504,363	772,197
Depletion, depreciation and accretion	145,349	121,833	296,323	169,426
Stock based compensation (note 9(e))	109,560	-	109,560	-
Interest	31,331	29,996	63,092	59,112
Foreign exchange (gain)	(6,580)	-	(1,351)	-
	(601,827)	(713,616)	(1,291,303)	(1,303,580)
Net operating loss	(264,538)	(449,787)	(652,890)	(684,038)
Other income and expenses				
Equity (loss) of Production Resources Inc. (note 5)	(6,062)	-	(6,062)	-
Unrealized (loss) gain on financial contract (note 11(c))	(54,681)	-	47,379	-
Net (loss) before income tax	(325,281)	(449,787)	(611,573)	(684,038)
Future income tax recovery	-	-	162,500	336,000
Net loss and comprehensive loss for the period	(325,281)	(449,787)	(449,073)	(348,038)
Deficit, beginning of period	(6,226,111)	(4,366,143)	(6,102,319)	(4,467,892)
Deficit, end of period	(6,551,392)	(4,815,930)	(6,551,392)	(4,815,930)
Basic and diluted income (loss) per share (note 9(f))	(0.01)	(0.01)	(0.01)	(0.01)
Weighted average shares outstanding during the period	50,159,446	30,012,753	48,437,224	30,012,753

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

Emerald Bay Energy Inc.

Statement of Cash Flows

For the three and six months ended June 30, 2010 and 2009

(Unaudited - expressed in Canadian dollars)

	Three months ended June 30, 2010 \$	Three months ended June 30, 2009 \$	Six months ended June 30, 2010 \$	Six months ended June 30, 2009 \$
Cash flows provided used in operating activities:				
Net income for the period	(325,281)	(449,787)	(449,073)	(348,038)
Items not affecting cash:				
Amortization of license fee	3,478	2,574	5,917	5,147
Depletion, depreciation and accretion	141,871	119,260	290,406	164,279
Stock based compensation	109,560	-	109,560	-
Unrealized loss (gain) on financial contract	54,681	-	(47,379)	-
Unrealized loss of Production Resources Inc.	6,062	-	6,062	-
Future income taxes	-	-	(162,500)	(336,000)
	<u>(9,629)</u>	<u>(327,953)</u>	<u>(247,007)</u>	<u>(514,612)</u>
Changes in non-cash working capital				
Change in accounts receivable	(16,019)	929,781	(698,061)	592,359
Change in prepaid expenditures	(1,312)	14,761	(4,969)	14,609
Change in accounts payable and accrued liabilities	(25,912)	(286,178)	686,813	(94,535)
	<u>(52,872)</u>	<u>330,411</u>	<u>(263,224)</u>	<u>(2,179)</u>
Cash flows used in investing activities				
Purchase of property and equipment	(64,626)	(251,589)	(147,501)	(639,973)
Sale of interest in subsidiary	(2,611)	-	214,500	-
	<u>(67,237)</u>	<u>(251,589)</u>	<u>66,999</u>	<u>(639,973)</u>
Cash flows provided by financing activities				
Receipt of related party receivable	1,566	-	4,769	-
Receipt of non-revolving bank loan	400,000	-	400,000	-
Repayment of long term debt	(4,956)	-	(6,035)	-
Bank demand loan (repayment)	(400,000)	(100,000)	(460,019)	450,000
	<u>(3,390)</u>	<u>(100,000)</u>	<u>(61,285)</u>	<u>450,000</u>
Change in cash and cash equivalents	(123,499)	(21,178)	(257,510)	(192,152)
Cash and cash equivalents, beginning of period	64,581	149,316	198,592	320,290
Cash and cash equivalents, end of period	(58,918)	128,138	(58,918)	128,138

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

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

1 Nature of operations

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

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

At June 30, 2010, the Company had not yet achieved profitable operations, had accumulated a deficit of \$6,551,392 since its inception (December 31, 2009 - \$6,102,319) and had a working capital deficiency of \$1,634,750 (December 31, 2009 - \$1,396,927) (excluding the bank loan), and expects to incur further losses in the development of its business, all of which cast significant doubt as to whether the Company is a going concern. The ability to continue as a going concern is dependent on obtaining continued financial support, completing public equity financing, or generating profitable operations in the future. Management is committed to raising additional capital to meet its exploration and operating obligation, however, additional equity financing is subject to the global financial markets and economic conditions, which have recently been disrupted and are volatile, and the debt and equity markets, which have been distressed, particularly for junior petroleum and natural gas companies. These factors, together with weak natural gas prices and the current unstable economic conditions, have caused, and will likely continue to cause significant doubt as to whether the Company is a going concern.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

2 Significant accounting policies

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

The results of operations for the three and six months ended June 30, 2010 are not necessarily indicative of those to be expected for the entire year ending December 31, 2010.

3 Adoption of accounting standard

Investments

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

4 Future accounting and reporting changes

Business Combinations, Consolidated Financial Statements and Non-controlling Interest

In January 2009, the CICA issued CICA Handbook Sections 1582: Business Combinations, Section 1601: Consolidations, and Section 1602: Non-controlling Interest. These sections replace the former CICA Handbook Section 1581: Business Combinations and Section 1600: Consolidated Financial Statements and establish a new section for accounting for a non-controlling interest in a subsidiary. CICA Handbook Section 1582 establishes standards for the accounting for a business combination, and states that all assets and liabilities of an acquired business will be recorded at fair value. Obligations for contingent considerations

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

and contingencies will also be recorded at fair value at the acquisition date. The standard also states that acquisition-related costs will be expensed as incurred and that restructuring charges will be expensed in the periods after the acquisition date. It provides the Canadian equivalent to IFRS 3, Business Combinations (January 2008). The section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011.

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

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

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

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

Equity

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

Comprehensive Revaluation of Assets and Liabilities

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

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

Accounting changes

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

5 Acquisition

On March 4, 2010, the Company announced that it, and a private partner, had acquired 100% of the shares of a private Texas based oil company, Production Resources Inc ("PRI"). Pursuant to the agreement, the Company and the private partner divided the interest, each obtaining 50%. As consideration for the purchase, the Company issued 5,000,000 common shares (\$0.08 CDN per share) and an 18 month consulting agreement valued at \$36,800 USD, for total consideration of \$425,000 USD.

On March 15, 2010, the Company sold 50% of its interest in the shares of PRI to Hillcrest Investments Ltd., a private Alberta company, for consideration of \$214,750. As a result, the Company's ownership interest in PRI decreased to 25%. The Company has accounted for the investment using the equity method.

The investment in PRI as at June 30, 2010 is as follows:

	CDN\$
Purchase of 50% interest in PRI	437,919
Disposition of 50% interest in PRI to Hillcrest	(214,750)
Share of losses for the period	(6,062)
Net investment	217,107

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

6 Property and equipment

	June 30, 2010		
	Cost	Accumulated depletion & depreciation	Net book value
	\$	\$	\$
Oil and gas properties	9,736,939	4,917,551	4,819,388
Other	297,527	152,945	144,582
	<u>10,034,466</u>	<u>5,070,496</u>	<u>4,963,970</u>

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

The Company applied the ceiling test to its petroleum and natural gas properties at June 30, 2010 and determined that there was no impairment of costs which would require a write down.

7 Asset Retirement Obligation

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

As at June 30, 2010, the Company estimated the total undiscounted amount of cash flows required to settle its ARO to be \$312,558 (December 31, 2009 - \$312,558), which are estimated to be incurred over the next 15 years. The Company calculated ARO using a credit adjusted risk free interest rate of 7.5% and an inflation rate of 2%, which resulted in the recording of ARO of \$137,055 (December 31, 2009 - \$131,757).

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

	June 30, 2010
	\$
Balance, beginning of period	131,757
Accretion	5,298
Balance, end of period	<u>137,055</u>

8 Bank Loan

The Company has a \$3,000,000 (December 31, 2009 - \$3,250,000) revolving operating demand loan (the "Revolving Loan"), of which \$2,475,000 (December 31, 2009 - \$2,935,019), has been drawn at June 30, 2010. Interest on the revolving loan is calculated at the bank's prime rate plus 2.00% (December 31, 2009 - bank's prime rate plus 1.50%).

During the three months ended June 30, 2010, the Company obtained a non-revolving demand loan (the "Non-revolving Loan") of \$400,000, through the same bank holding the revolving loan. Interest on the non-revolving loan is calculated at the bank's prime rate plus 2.50%.

Security for the loans consists of a \$10,000,000 Debenture with a floating charge over all assets of the Company with a Negative Pledge and Undertaking to provide fixed charges on the Borrower's major producing petroleum properties at the request of the bank. The Company is required to maintain certain covenants, which the Company is in violation of as at June 30, 2010 (note 12). The bank has not made demand of the Company's credit facilities but retains the right to do so.

9 Share Capital

a) Authorized

Unlimited number of common shares with voting rights.

Unlimited number of preferred shares, issuable in series.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

b) Issued

	Number of Common Shares	Amount \$
Outstanding, December 31, 2009	45,159,446	5,830,596
Shares issued on purchase of non-controlled subsidiary(i)	5,000,000	400,000
Tax effect of flow-through shares(ii)	-	(162,500)
Share issue costs	-	2,147
Outstanding, June 30, 2010	50,159,446	6,070,243

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

(ii) The Company committed to incur \$650,000 on qualifying exploration and development expenditures prior to December 31, 2010 relating to flow-through shares issued in 2009. The Company has renounced these expenditures as at December 31, 2009 and filed the necessary documents with the Canada Revenue Agency in 2010. Accordingly, the future income tax of \$162,500 has been recorded in the period. As at June 30, 2010, the total of \$563,873 remains to be incurred.

c) Warrants

	Number of Warrants	Amount \$
Balance, December 31, 2009	9,625,000	102,083
Expiry of warrants	(1,500,000)	-
Balance, June 30, 2010	8,125,000	102,083

On June 23, 2010, 1,500,000 of the warrants issued expired unexercised.

d) Stock options outstanding

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

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

discretion of the Board of Directors. However, the maximum option term shall not exceed five years.

During the three and six month period ended June 30, 2010, the Company granted 3,450,000 stock options, 1,163,117 options expired unexercised, and there were no exercises or cancellations. The following table summarizes information about the Company's stock options outstanding at June 30, 2010:

	June 30, 2010		December 31, 2009	
	Number of options	Weighted Average	Number of options	Weighted Average
		Exercise price		Exercise price
		\$		\$
Employee, Directors, Consultants				
Stock options, beginning of period	1,850,000	0.24	2,275,000	0.26
Granted	3,450,000	0.10	-	-
Expired	(550,000)	0.25	(425,000)	0.32
Stock options outstanding, end of period	4,750,000	0.13	1,850,000	0.24

	June 30, 2010		December 31, 2009	
	Number of options	Weighted Average	Number of options	Weighted Average
		Exercise price		Exercise price
		\$		\$
Agent Options				
Agent options, beginning of period	1,090,617	0.12	613,117	0.15
Granted	-	-	477,500	0.08
Expired	(613,117)	0.15	-	-
Agent options outstanding, end of period	477,500	0.08	1,090,617	0.12

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

<u>Exercise prices</u>	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price (\$)
\$0.08	477,500	0.37	0.08
\$0.10	3,450,000	4.53	0.10
\$0.17	200,000	2.32	0.17
\$0.25	1,100,000	0.54	0.25
	5,227,500	3.19	0.13

As at June 30, 2010 all outstanding options have vested and are exercisable.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

e) Stock based compensation

During the three and six months ended June 30, 2010, the Company granted 3,450,000 options to officers, directors and consultants. The terms of the grant are consistent with the Plan and the options are exercisable at \$0.10 per option, 300,000 of which expire 2 years after the grant date, and 3,150,000 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:

Risk-free interest rate	2.62%
Expected life	4.7 years
Expected volatility	66.27%
Fair value per option	0.032

Compensation expense recognized for the three and six month period ended June 30, 2010 was \$109,560 (June 30, 2009 - \$nil), all of which has been recorded as an offsetting credit to contributed surplus.

f) Diluted (loss) earnings per share

Basic earnings per share are calculated based on the weighted average number of shares outstanding during the three and six months ended June 30, 2010 of 50,159,446 and 48,437,224, respectively. The treasury stock method is used for the calculation of diluted loss per share. Under this method, it is assumed that proceeds from the exercise of dilutive securities are used by the Company to repurchase Company shares at the average price during the period. During the period, the Company did not have any dilutive securities outstanding.

10 Related Parties

a) The following amounts are due by related parties:

	June 30, 2010	December 31, 2009
	\$	\$
Note receivable from officer (i)	221,750	218,500
Fair value allowance (ii)	(206,710)	(206,710)
Net note receivable	15,040	11,790
Advance fees (iii)	43,429	51,448
	<u>58,469</u>	<u>63,238</u>

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

- (i) A promissory note was issued to an officer of the Company bearing interest at 3% per annum and repayable by December 31, 2012, unless the officer's employment is terminated or he is petitioned into bankruptcy wherein the note and accrued interest becomes immediately payable. The note is secured by 393,000 common shares of the Company which had a fair value of \$15,720 at June 30, 2010 (December 31, 2009 - \$35,370).
 - (ii) The fair value allowance was determined in 2008, based on the market value at December 31, 2008 of the secured shares. The Company has not provided an allowance to the estimated fair value of the 393,000 common shares held as security as the fair value at June 30, 2010 and December 31, 2009 exceeded the carrying amount.
 - (iii) A director was advanced fees in relation to efforts to finance and advance the Company's drilling technology. At June 30, 2010 \$43,429 (December 31, 2009 - \$51,448) remains outstanding. There is no guarantee that such efforts will be successful and if such efforts are not successful, the full balance will be repaid by December 31, 2010.
- b) Related party transactions not disclosed elsewhere in these financial statements are as follows:

For the three month period ended June 30, 2010:

- (i) Aggregate fees of \$79,275 (June 30, 2009 - \$69,685) were charged by directors and officers of the Company and were expensed as general and administrative expenses.
- (ii) Aggregate legal fees of \$nil (June 30, 2009 - \$2,294) were charged by a law firm in which a director of the Company is a partner, and were expensed as general and administrative expenses.
- (iii) Aggregate fees of \$10,800 (June 30, 2009 - \$27,720) 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. These fees were expensed as general and administrative expenses.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

For the six month period ended June 30, 2010:

- (iv) Aggregate fees of \$123,407 (June 30, 2009 - \$173,095) were charged by officers of the Company and were expensed as general and administrative expenses.
- (v) Aggregate legal fees of \$7,854 (June 30, 2009 - \$8,108) were charged by a law firm in which a director of the Company is a partner of, and were expensed as general and administrative expenses.
- (vi) Aggregate fees of \$21,600 (June 30, 2009 - \$27,720) 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. These fees were expensed as general and administrative expenses.
- (vii) Included in accounts payable at June 30, 2010 was \$29,600 owing to related parties of the Company.

Transactions in the normal course of operations are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

11 Financial Instruments and Risk Management

a) Fair values

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

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

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

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

The level within which the financial asset or liability is classified is determined based on the lowest level of significant input to the fair value measurement. At June 30, 2010, the Company's cash and cash equivalents, the financial contract, and the equity investment have been assessed based on the fair value hierarchy above. Cash and cash equivalents are assessed through level 1, the financial contract through level 2, and the equity investment through level 3. Assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the placement within the fair value hierarchy.

b) **Credit risk**

The majority of the Company's accounts receivable are due from joint venture partners in the oil and gas industry and from purchasers of the Company's petroleum and natural gas production and are subject to the same industry factors such as commodity price fluctuations and escalating costs. The Company generally extends unsecured credit to these customers and therefore, the collection of accounts receivable may be affected by changes in economic or other conditions. Management believes risk is mitigated by the size and reputation of the companies to which they extend credit. The Company has not experienced any credit loss in the collection of accounts receivable in the period ended June 30, 2010.

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

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

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

c) **Market risk**

Market risk is the risk that changes in market prices, such as commodity prices and interest rates, will affect the Company's net earnings or the value of financial instruments. These risks are generally outside the control of the Company.

Commodity price risk

The Company is exposed to commodity price risk on oil and gas revenues. As a means to mitigate the exposure to commodity price volatility, during September 2009 the Company entered into a derivative financial instrument effective January 1, 2010 to December 31, 2010, which collared the received price of natural gas between \$4.53/GJ and \$7.53/GJ for 500 GJ/day.

The Company's derivative financial instruments are classified as held-for-trading and are reported at fair value with changes in fair value recorded through the statement of loss, comprehensive loss, and deficit. The following table summarizes the fair value as at June 30, 2010 and the change in fair value for the three month period ended June 30, 2010:

Financial contract, March 31, 2010	102,060
Unrealized loss	(54,681)
Financial contract, June 30, 2010	<u>47,379</u>

At present, the Company produces primarily natural gas. A \$.50 mcf increase or decrease in the price received for natural gas would result in approximately a \$9,300 increase or decrease in the monthly Petroleum and Natural Gas sales.

Interest rate risk

The Company is exposed to interest rate risk on its revolving loan and non-revolving loan, which have interest rates of prime plus 2.00% and prime plus 2.5%, respectively. An estimated 1% increase or decrease in the interest rate would have affected the Company's statement of operations by \$13,289 for the six months ended June 30, 2010.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

d) Currency risk

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

Certain of the Company's financial instruments are exposed to fluctuations in the US dollar, including cash and cash equivalents, accounts receivable and accounts payable and accrued liabilities. As at June 30, 2010, 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 \$5,775 impact on the Company's earnings for the quarter.

e) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due. This may be the consequence of diminished cash flows resulting from lower product prices, production interruptions, or unexpected operating or capital cost increases. Liquidity difficulties could also occur if the Company's bankers were unable to continue to provide credit (when and if applicable) at a level and on terms compatible with the Company's capital requirements. The Company ensures, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, without incurring unacceptable losses or harm to the Company's reputation.

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

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

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

Net working capital deficiency	\$1,634,750	This amount is anticipated to be met out of additional share issuance in the 2010 fiscal period.
Bank debt (Note 8)	\$2,875,000	The Company anticipates issuing additional share capital to reduce this amount in 2010. This amount is secured by the Company's oil and gas assets which have value sufficient such that the Company has no reason to believe that the bank will require repayment within the next fiscal period.
Long term debt	\$101,241	Vehicle loans will be paid over 5 years out of normal cash flow.

12 Capital management

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

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

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

The Company is bound by certain debt covenants. These covenants include maintaining a Working Capital Ratio of not less than 1.0 to 1.0 at all times. The Working Capital ratio for this purpose is defined as Current Assets (including the un-drawn availability under the Credit Facility A) to Current Liabilities (excluding any current portion of Bank Debt). As at June 30, 2010, the Company was in violation of this bank covenant with a ratio of 0.68:1. The bank has not made demand of the Company's credit facilities but retains the right to do so.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

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

13 Commitments

- a) Under a lease agreement for five (5) years commencing April 1, 2009 and ending March 31, 2014, the Company has committed to payments of \$5,420 per month under a rental agreement for office space.
- b) The Company has entered into various vehicle loan agreements with estimated minimum annual payments of approximately \$27,800 per year through 2015. Total annual principle repayments for fiscal years 2010 through to 2015 are respectively as follows: \$18,050, \$22,075, \$23,345, \$24,688, \$26,110 and \$15,825.
- c) As partial consideration for the non-controlling acquisition of the shares of a Texas oil and gas company, the Company has entered into a consulting contract aggregating \$37,919 (USD -\$36,800). The contract commences March 1, 2010 and has a term of 18 months.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and six months ended June 30, 2010

(Unaudited - expressed in Canadian dollars)

14 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. Geographical segmentation is as follows:

	Three months ended June 30, 2010 (\$)		
	Canada	United States	Total
Petroleum and natural gas sales	329,723	45,460	375,183
Interest income	1,635	23	1,658
Depletion, depreciation and accretion	124,904	20,445	145,349
Net loss	(240,920)	(84,361)	(325,281)

	Six months ended June 30, 2010 (\$)		
	Canada	United States	Total
Petroleum and natural gas sales	707,299	65,747	773,046
Interest income	4,992	(3,508)	1,484
Depletion, depreciation and accretion	267,809	28,514	296,323
Net loss	(328,040)	(121,033)	(449,073)
Property and equipment	4,617,897	346,073	4,963,970
License	5,918	-	5,918