



Emerald Bay Energy

**Emerald Bay Energy Inc.
Financial Statements
For the nine months ended
September 30, 2009
(Prepared by Management - Unaudited)**

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UNAUDITED INTERIM FINANCIAL STATEMENTS

In Accordance with National Instrument 51-102 released by the Canadian Securities Administrators, the Company Discloses that its auditors have not reviewed the unaudited financial statements for the period ended September 30, 2009

Emerald Bay Energy Inc.
Balance Sheets
Prepared by Management - Unaudited

	September 30	December 31
	2009	2008
		Audited
Assets		
Current		
Cash	\$ 71,687	\$ 259,159
Short term investments	51,692	61,131
Accounts receivable	885,763	1,396,299
Prepaid expenses	37,225	45,004
	1,046,366	1,761,593
Due from related parties (Note 8)	11,790	11,790
Prepaid expenses and deposits	10,104	8,234
Accounts receivable	-	61,000
Property and equipment (Note 4)	5,204,465	4,643,003
License	12,869	20,589
	\$ 6,285,594	\$ 6,506,209
Liabilities and Shareholders' Equity		
Current		
Bank overdraft	\$ 61,483	\$ -
Bank demand loan (Note 6)	2,974,195	2,275,000
Accounts payable and accrued liabilities	2,065,397	2,128,281
	5,101,075	4,403,281
Asset retirement obligation	151,907	104,942
	5,252,982	4,508,223
Going concern assumption (Note 2)		
Shareholders' equity		
Share capital (Note 5(b))	5,367,729	5,703,729
Contributed surplus	762,149	762,149
Deficit	(5,097,266)	(4,467,892)
	1,032,612	1,997,986
	\$ 6,285,594	\$ 6,506,209

"Shelby D. Beattie" Director
Shelby D. Beattie

"Gibson C. Scott" Director
Gibson C. Scott

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

Emerald Bay Energy Inc.
Statements of Operations, Comprehensive Loss and Deficit
Prepared by Management - Unaudited

	For the three months ended		For the nine months ended	
	Sept 30 2009	Sept 30 2008	Sept 30 2009	Sept 30 2008
Revenue				
Petroleum and natural gas sales	\$ 301,107	\$ 756,783	\$ 1,001,987	\$ 2,399,505
Royalties	<u>(42,068)</u>	<u>(189,315)</u>	<u>(125,609)</u>	<u>(501,287)</u>
	<u>259,039</u>	<u>567,468</u>	<u>876,378</u>	<u>1,898,218</u>
Expenses				
Operating	178,365	226,390	481,210	590,872
General and administrative	184,556	320,471	956,753	1,012,962
Stock option expense	-	-	-	-
Depletion, amortization and accretion	139,879	116,795	309,305	405,333
Interest	41,986	36,193	101,098	117,045
Allowance for bad debt	-	81,196	-	81,196
	<u>544,786</u>	<u>781,045</u>	<u>1,848,366</u>	<u>2,207,408</u>
Loss from operations	<u>(285,747)</u>	<u>(213,577)</u>	<u>(971,988)</u>	<u>(309,190)</u>
Other income				
Interest	1,782	1,668	3,985	6,249
Gain on sale of inventory	2,629	-	2,629	-
	<u>4,411</u>	<u>1,668</u>	<u>6,614</u>	<u>6,249</u>
Loss for the period before tax	<u>(281,336)</u>	<u>(211,909)</u>	<u>(965,374)</u>	<u>(302,941)</u>
Income tax				
Future income tax recovery	-	-	366,000	-
	<u>-</u>	<u>-</u>	<u>366,000</u>	<u>-</u>
Net loss and comprehensive loss for the period	<u>(281,336)</u>	<u>(211,909)</u>	<u>(629,374)</u>	<u>(302,941)</u>
Deficit, beginning of period	<u>(4,815,930)</u>	<u>(3,836,649)</u>	<u>(4,467,892)</u>	<u>(3,745,617)</u>
Deficit, end of period	<u>\$ (5,097,266)</u>	<u>\$ (4,048,558)</u>	<u>\$ (5,097,266)</u>	<u>\$ (4,048,558)</u>
Loss per common share basic and diluted (Note 5(d))				
	\$ (0.01)	\$ (0.00)	\$ (0.02)	\$ (0.01)
Weighted average number of shares	30,012,753	29,820,506	30,012,753	29,820,506

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

Emerald Bay Energy Inc.
Statements of Cash Flows
Prepared by Management - Unaudited

	For the three months ended		For the nine months ended	
	Sept 30 2009	Sept 30 2008	Sept 30 2009	Sept 30 2008
Cash flows from operating activities				
Net loss for the period	\$ (281,336)	\$ (211,909)	\$ (629,374)	\$ (302,941)
Adjustments for:				
Depletion, amortization and accretion	137,306	114,221	301,585	397,613
Amortization of license fee	2,574	2,574	7,721	7,721
Future income taxes	-	-	-	-
Stock option expense	-	-	-	-
Allowance for bad debt	-	81,196	-	81,196
Cash flow from operations	(141,456)	(13,918)	(320,069)	183,589
Changes in non-cash operating balances				
Accounts receivable	(20,822)	106,712	571,536	(113,175)
Prepaid expenses and deposits	(8,700)	14,750	5,909	(1,321)
Accounts payable	31,652	260,531	(62,884)	(286,581)
Accrued liabilities	-	(69,500)	-	(69,500)
	(139,326)	298,575	194,493	(286,988)
Cash flows from financing activities				
Renunciation of flow-thru benefit (Note 5)	-	-	(336,000)	-
Bank demand loan (repayment)	249,195	(650,000)	699,195	300,000
Issuance of share capital, net of costs	-	822,557	-	822,557
	249,195	172,557	363,195	1,122,557
Cash flows from investing activities				
Purchases of property and equipment	(176,110)	(428,352)	(816,081)	(771,060)
Increase (decrease) in cash and equivalents	(66,243)	42,780	(258,394)	64,509
Cash and equivalents, beginning of period	128,139	90,440	320,290	68,711
Cash and equivalents, end of period	\$ 61,896	\$ 133,220	\$ 61,896	\$ 133,220

Cash and equivalents, end of period

	2009	2008
Cash	\$ 71,687	\$ 83,220
Short term investments	51,692	50,000
Bank overdraft	(61,483)	-
	\$ 61,896	\$ 133,220

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

Emerald Bay Energy Inc.
Notes To Financial Statements
Prepared by Management - Unaudited

September 30, 2009

1. Basis of Presentation

The interim financial statements of Emerald Bay Energy Inc. (the "Company") have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") and are consistent with the presentation and disclosure in the audited financial statements and notes thereto for the year ended December 31, 2008. The interim financial statements contain disclosures which are supplemental to the Company's annual financial statements. Certain disclosures, which are normally required to be included in the notes to the annual financial statements, have been condensed or omitted. The interim financial statements should be read in conjunction with the Company's audited financial statements and notes thereof for the year ended December 31, 2008.

2. Going Concern Assumption

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities and commitments in the normal course of business. The Company has a \$ 4,054,709 working capital deficiency at September 30, 2009.

Management is committed to raising additional capital to meet exploration and operating obligations. While management has been successful in the past in obtaining financing, there is no assurance that sufficient funds will be raised in the future. The Company's ability to continue as a going concern is dependent upon the Company's ability to raise additional equity to meet its current working capital shortfall and provide for future operational needs. See subsequent event (Note 10).

These financial statements do not give effect to adjustments to the carrying values of assets and liabilities and reported revenue and expenses that would be necessary should the Company be unable to continue as a going concern.

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3. Adoption of New Accounting Policies

Financial Instruments – disclosures and Presentation

Effective January 1, 2008, the Company adopted two new Canadian Institute of Chartered Accountants (“CICA”) standards. Handbook Section 3862, Financial Instruments – Disclosures and Handbook Section 3863, Financial Instruments – Presentation. These Handbook Sections replaced existing Handbook Section 3861, Financial Instruments – Presentation and Disclosure. The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed. Specifically, section 3862 requires disclosure of the significance of financial instruments on the Company’s financial position. In addition, the guidance outlines revised requirements for the disclosure of qualitative and quantitative information regarding exposure to risks arising from financial instruments. The new presentation standard carries forward the former presentation requirements.

Comprehensive Income

The Company does not have any items to be accounted as components of other comprehensive income (“OCI”) and as a result comprehensive income equals net (loss) earnings.

Capital Disclosures

Effective January 1, 2008, the Company adopted Handbook Section 1535, Capital Disclosures which requires companies to disclose their objectives, policies and processes for managing capital, the nature of externally imposed capital requirements, how the requirements are incorporated into the Company’s management of capital, whether the requirements have been complied with, or consequence of noncompliance and an explanation of how the Company is meeting its objectives for managing capital. In addition, quantitative disclosures regarding capital are required.

In addition, the Company has assessed new and revised accounting pronouncements that have been issued that are not yet effective and determined that the following may have a significant impact on the Company.

International Financial Reporting Standards

In January 2006, the CICA Accounting Standards Board adopted a strategic plan for the direction of accounting standards in Canada. As part of the plan, accounting standards in Canada for public companies will converge with International Financial Reporting Standards (“IFRS”) on January 1, 2011. The Company continues to monitor and assess the impact of the convergence of Canadian GAAP and IFRS.

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4. Property and Equipment

	September 30, 2009			December 31, 2008		
	Cost	Accumulated Depletion and Amortization	Net Book Value	Cost	Accumulated Depletion and Amortization	Net Book Value
Petroleum and natural gas properties	\$9,110,229	\$ 4,052,344	\$5,057,885	\$8,350,938	\$ 3,778,576	\$4,572,362
Furniture and Equipment	287,863	141,283	146,580	191,937	121,296	70,641
	\$9,398,092	\$ 4,193,627	\$5,204,465	\$8,542,875	\$ 3,899,872	\$4,643,003

No general administrative expenses have been capitalized to property and equipment.

The Company applied the ceiling test to its petroleum and natural gas properties at December 31, 2008 and determined that there was no impairment of costs requiring a write down in either of its cost centres.

5. Equity Instruments

- a) Authorized
 Unlimited number of common voting shares
 Unlimited number of preferred shares, issuable in series.
- b) Issued

	September 30, 2009		December 31, 2008	
	Number of Shares	Amount	Number of Shares	Amount
Common shares issued and issuable for cash See subsequent event (Note #10)				
Balance, beginning of period	37,034,446	\$5,681,646	27,903,277	\$ 4,729,136
Private placement September 2008			6,131,169	919,375
Private placement December 2008			3,000,000	300,000
Value assigned to warrants				(22,083)
Share issue costs				(245,082)
Tax effect on renunciation of flow-through shares		(336,000)		
Balance, end of period	37,034,446	5,345,646	37,034,446	5,681,646
Warrants outstanding beginning of period	1,500,000	22,083	-	-
Warrants	-	-	1,500,000	22,083
Balance, end of period	1,500,000	22,083	1,500,000	22,083
Equity instruments balance September 30, 2008		\$5,367,729		\$ 5,703,729

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5. Equity Instruments - continued

c) Stock options

The Company has established a stock option plan whereby the Company may grant directors, officers, employees and consultants up to a maximum of 10% of the issued common shares. The stock options granted on March 29, 2004 vest evenly over a 3 year period from the date of grant and expire 5 years after the date of grant. All other stock options granted vest immediately after the date of grant and expire 5 years after the date of grant.

	September 30, 2009		December 31, 2008	
	Number of options	Weighted average exercise price	Number of options	Weighted Average Exercise price
Stock options, beginning of period	2,275,000	\$ 0.22	2,525,000	\$ 0.26
Granted				
Expired	(425,000)	0.32	(250,000)	0.25
Stock options outstanding, end of period	<u>1,850,000</u>	<u>\$ 0.22</u>	<u>2,275,000</u>	<u>\$ 0.22</u>
Exercisable, end of period	<u>1,850,000</u>	<u>\$ 0.22</u>	<u>2,275,000</u>	<u>\$ 0.22</u>

The stock options outstanding as at September 30, 2009 are as follows:

<u>Exercise prices</u>	<u>Options outstanding</u>			<u>Options exercisable</u>	
	<u>Options outstanding</u>	<u>Weighted average remaining term (years)</u>	<u>Weighted average exercise price</u>	<u>Options exercisable</u>	<u>Weighted average exercise price</u>
\$0.25	1,850,000	2.0	0.25	1,850,000	0.25
	<u>1,850,000</u>	<u>2.0</u>	<u>\$ 0.25</u>	<u>1,850,000</u>	<u>\$ 0.25</u>

d) Diluted loss per share

The exercise of options and warrants would be anti-dilutive.

6. Bank Loan

The Company has a \$3,000,000 (2008 - \$3,000,000) revolving operating demand loan, of which \$2,974,195 (2008 - \$2,275,000) plus accrued interest, has been drawn at September 30, 2009. Interest is calculated at the bank's prime rate plus 1.25%.

Security for the loan consists of a \$10,000,000 Debenture with a floating charge over all assets of the Company with a Negative Pledge and Undertaking to provide fixed charges on the Borrower's major producing petroleum properties at the request of the bank.

The Company is 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 September 30, 2009, the ratio was .53 to 1.0.

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7. Financial Instruments and Risk Management

The Company has the following financial instruments:

Accounts receivable and deposits are designated as loans and receivables and are measured at amortized cost. Accounts payable and accrued liabilities and bank debt are designated as other financial liabilities and are measured at amortized cost.

a) Market risk

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

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 2008.

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 from its partners on capital projects before they commence.

The Company had a receivable from SemCanada Crude which entered into CCAA proceedings in July 21 2008. The Company's receivable has been written down to \$846. The net loss to the Company was \$19,992 which was recognized in the 4th quarter 2008.

c) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they are due. The Company's approach to managing liquidity is to ensure that it will have sufficient liquidity to meet its liabilities when due. The nature of the oil and gas industry is very capital intensive. As a result, the Company prepares annual capital expenditure budgets and utilizes authorizations for expenditures for projects to manage capital expenditures. Refer to note 7 for disclosure related to the management of capital.

d) Fair value of financial instruments

The Company's accounts receivable, deposits, bank debt and accounts payable and accrued liabilities approximates their carrying value due to their short terms to maturity and the floating interest rate on the Company's debt.

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8. Due From Related Parties and Related Party Transactions

a) The following amounts are due by related parties:

	Sept 30, 2009	Dec 31, 2008
Due from related party		
Note receivable from officer (i)	\$ 218,500	\$ 218,500
Fair value allowance	(206,710)	(206,710)
	\$ 11,790	\$ 11,790

- (i) Note receivable from officer
 Promissory note bearing interest at 3% per annum and repayable by December 31, 2009. The note is secured by 393,000 common shares of the Company.
- (ii) For financial statement purposes the Company has provided an allowance to the estimated fair value of the underlying security \$11,790 (2008 - \$11,790)

b) Except as disclosed elsewhere in the financial statements, the Company was involved in the following related party transactions for the third quarter ended September 30, 2009.

- (i) Directors and officers, have charged the Company for the nine months ended September 30, 2009 \$217,425(2008 - \$176,713) for services.
- (ii) A law firm in which a director is a partner has charged the Company for the nine months ended September 30, 2009 \$8,742 (2008 - \$57,021) in legal fees.
- (iii) An oil and gas completions, operations, geological and consulting firm owned 100% by a director has charged the Company for the nine months ended September 30, 2009 \$70,350 (2008 - \$118,650) in consulting fees.
- (iv) A director was advanced fees totaling \$NIL (2008 – \$20,961) in relation to efforts to finance and advance the Company's drilling technology. There is no guarantee that such effort will be successful. If such efforts are not successful, the full balance will be repaid in 2009. The above amount is included in accounts and cash call receivable at year end.
- (v) A U.S. Company, providing field operation services in relation to operating the company's U.S. properties, owned and controlled by an officer and a director has charged the Company \$41,580 (2008 - \$76,282). Included in accounts receivable is \$32,391 of advances to the Company for future expenses

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.

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9. 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's 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 September 30, 2009, the ratio was .53 to 1.0.

10. Subsequent Event

Subsequent to the quarter end, the Company closed a Private Placement. Pursuant to the private placement, 6,250,000 units ("Units") were issued at a price of \$0.08 per Unit, for aggregate consideration of \$500,000 (of which \$78,000 originated from Insiders of the Company). Each Unit consisted of one (1) common share of the Company (issued either as a common share or as a "flow-through share" pursuant to the Income Tax Act (Canada) (the "Flow-Through Share") at the subscribers option) and one (1) non-transferable share purchase warrant (the "Warrant") (each full Warrant shall entitle the holder thereof to purchase one (1) additional common share of the Company for a period of 12 months from the issuance of the Units at a price of \$0.15) (the "Offering"). Of the total 6,250,000 common shares issued under this Offering an aggregate 5,812,500 were issued as Flow-Through Shares. A finder's fee of \$17,500 and a due diligence fee of \$17,500 (plus GST) was paid to First Canadian Securities Inc., a division of Limited Market Dealer Inc. of Toronto, Ontario along with the issuance of 437,500 finder's options (the "Finder's Options"). A finder's fee of \$3,200 was paid to Brandt Securities Limited of Toronto, Ontario along with the issuance of 40,000 Finder's Options. Each Finder's Option is exercisable into one Unit (on a non-flow-through basis) of the Company (on the same terms and conditions as those received by the subscribers under this Offering).