



Emerald Bay Energy

**Emerald Bay Energy Inc.
Audited Financial Statements
For the years ended December 31, 2006 and 2005**

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To the Shareholders of Emerald Bay Energy Inc.

We have audited the balance sheets of Emerald Bay Energy Inc. as at December 31, 2006 and 2005 and the statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

“MacKay LLP”
Chartered Accountants

Calgary, Canada
April 16, 2007

**Emerald Bay Energy Inc.
Balance Sheets**

As at December 31	2006	2005
Assets		
Current		
Cash	\$ 261,944	\$ 3,203,638
Short term investments	60,560	64,060
Accounts and cash call receivable (Note 13)	999,101	815,073
Prepaid expenses and deposits	10,889	2,655
Inventory	6,400	-
	1,338,894	4,085,426
Due from related party (Note 7)	74,670	218,500
Property and equipment (Note 3)	3,911,678	2,329,707
License (Note 5)	41,177	51,471
Deposits	24,194	20,237
	\$ 5,390,613	\$ 6,705,341
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Liabilities and Shareholders' Equity		
Current		
Bank demand loan (Note 6)	\$ 1,107,224	\$ -
Note payable (Note 6)	-	2,000,000
Accounts payable and accrued liabilities	1,494,430	1,191,735
	2,601,654	3,191,735
Future tax liability (Note 10)	380,000	-
Asset retirement obligations (Note 4)	149,505	117,021
	3,131,159	3,308,756
Contingencies (Note 11)		
Shareholders' equity		
Equity instruments (Note 8(b))	5,072,851	5,695,691
Contributed surplus (Note 9)	369,623	150,351
Deficit	(3,183,020)	(2,449,457)
	2,259,454	3,396,585
	\$ 5,390,613	\$ 6,705,341

“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 and Deficit

For the years ended December 31	2006	2005
Revenue		
Petroleum and natural gas sales	\$ 2,708,995	\$ 2,320,876
Royalties	(749,817)	(618,588)
Alberta Royalty Tax Credits	107,338	74,839
	<u>2,066,516</u>	<u>1,777,127</u>
Expenses		
Operating	635,854	360,841
General and administrative	1,191,944	1,413,371
Stock based compensation	180,945	85,710
Research and development	292	179,790
Depletion, amortization and accretion	927,784	516,724
Interest	33,745	90,611
Fair value allowance (Note 7 a) (ii))	143,830	---
	<u>3,114,394</u>	<u>2,647,047</u>
Loss from operations	<u>(1,047,878)</u>	<u>(869,920)</u>
Other income		
Interest	8,315	6,610
Loss before income taxes	<u>(1,039,563)</u>	<u>(863,310)</u>
Income tax recovery (Note 10)		
Future	306,000	---
	<u>306,000</u>	<u>---</u>
Loss for the year	<u>(733,563)</u>	<u>(863,310)</u>
Deficit, beginning of year	(2,449,457)	(1,586,147)
Deficit, end of year	<u>\$ (3,183,020)</u>	<u>\$ (2,449,457)</u>
Loss per common share (Note 8(d))		
	<u>\$ (0.03)</u>	<u>\$ (0.05)</u>
Weighted average number of shares		
	27,868,806	16,158,956

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

**Emerald Bay Energy Inc.
Statements of Cash Flows**

For the years ended December 31

2006

2005

Cash flows from operating activities

Loss for the year	\$ (733,563)	\$ (863,310)
Adjustments for:		
Depletion, amortization and accretion	917,490	506,430
Amortization of license fee	10,294	10,294
Fair value allowance	143,830	-
Future income tax	(306,000)	-
Stock based compensation	180,945	85,710
	212,996	(260,876)

Changes in non-cash operating balances

Accounts and cash calls receivable	(184,028)	(334,780)
Prepaid expenses and deposits	(12,191)	32,428
Accounts payable	(240,395)	(1,458,427)
Accrued liabilities	(69,500)	(114,500)
Purchase of inventory	6,400	-
	(286,718)	(2,136,155)

Cash flows from financing activities

Bank demand loan (repayment)	1,107,224	(360,000)
Advances from note payable (repayment)	(2,000,000)	2,000,000
Related party advances (repayments)	-	(16,288)
Issuance of share capital, net of costs	101,487	3,746,324
	(791,289)	5,370,036

Cash flows from investing activities

Purchases of property and equipment	(2,466,977)	(759,998)
Changes in non-cash investing balances	599,790	695,655
	(1,867,187)	(64,343)

Increase (decrease) in cash and equivalents

	(2,945,194)	3,169,538
Cash and cash equivalents, beginning of year	3,267,698	98,160

Cash and cash equivalents, end of year

	\$ 322,504	\$ 3,267,698
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Cash and cash equivalents, end of year

2006

2005

Cash	\$ 261,944	\$ 3,203,638
Short term investments	60,560	64,060
	\$ 322,504	\$ 3,267,698

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

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2006 and 2005

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.

2. Summary of Significant Accounting Policies

The financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The financial statements have, in management's opinion, been properly prepared using careful judgement with reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

a) Property and equipment

The Company follows the full cost method of accounting for oil and gas operations whereby all costs of exploring for and developing oil and gas reserves are initially capitalized. Such costs include land acquisition costs, geological and geophysical expenses, carrying charges on non-producing properties, costs of drilling and overhead charges directly related to acquisition and exploration activities.

Costs capitalized, together with the costs of production equipment, are depleted on the unit-of-production method based on the estimated gross proved reserves. Petroleum products and reserves are converted to equivalent units of natural gas at approximately 6,000 cubic feet to 1 barrel of oil.

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion calculations. Proceeds from the sale of petroleum and natural gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would significantly alter the rate of depletion.

In applying the full cost method, the Company calculates a ceiling test whereby the carrying value of property and equipment is compared to the sum of the undiscounted cash flows expected to result from the future production of proved reserves and the sale of unproved properties. Cash flows are based on third party quoted forward prices, adjusted for transportation and quality differentials. Should the ceiling test result in an excess of carrying value, the Company would then measure the amount of impairment by comparing the carrying amounts of property and equipment to an amount equal to the estimated net present value of future cash flows from proved plus probable reserves and the sale of unproved properties. The Company's risk-free interest rate is used to arrive at the net present value of the future cash flows. Any excess carrying would be recorded as a permanent impairment.

December 31, 2006 and 2005

2. Summary of Significant Accounting Policies – Continued

Furniture and equipment are carried at cost and amortized over the estimated useful lives of the asset on a straight-line basis over three to five years.

b) Joint venture operations

The majority of the Company's petroleum and natural gas exploration activities are conducted jointly with others. These financial statements reflect only the Company's proportionate interest in such activities.

c) Asset retirement obligations

The company provides for asset retirement obligations for associated long-lived assets that result from the acquisition, construction, development or normal use for the assets and requires that a liability for an asset retirement obligation be recognized when incurred, recorded at fair value and classified as a liability in the balance sheet. When the liability is initially recorded, the entity will capitalize the net present value of the cost and increase the carrying value of the related long-lived asset. Asset retirement obligations represent future liabilities, and, as a result, accretion expense will be accrued on this liability until the obligation is satisfied. At the same time, the capitalized cost will be depleted over the estimated useful life of the related asset. At settlement date, the entity will settle the obligation for its recorded amount or recognize a gain or loss upon settlement.

d) Revenue recognition

Revenue associated with the sales of petroleum and natural gas production owned by the Company is recognized when the title passes from the Company to its customers. Transportation costs are not netted against revenue but included with production costs, as they are not material to show separately. Alberta Royalty Tax Credits are deducted from royalty expense. Commodities sold by the Company below or above its working interest share in the related resource properties may result in production underliftings, which is recorded in inventory. Product inventories are valued at the lower of average cost and net realizable value on a first-in, first-out basis.

e) Flow-through equity instruments

Expenditure deductions for income tax purposes related to exploratory activities funded by flow-through share/warrants arrangements are renounced to investors in accordance with income tax legislation. A future tax liability is recognized upon the renunciation of tax pools and share capital is reduced by the estimated costs of the renounced tax deductions at the time of filings with the proper tax authorities.

f) Financial instruments

The Company carries a number of financial instruments. It is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.

g) Measurement uncertainty

The amounts recorded for depletion and amortization of petroleum and natural gas properties and equipment and the provision for asset retirement obligations are based on estimates. The ceiling test is based on estimates of proved reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes and estimates in future periods could be significant.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2006 and 2005

2. Summary of Significant Accounting Policies - Continued

The financial statements include accruals based on the terms of existing joint venture agreements. Due to varying interpretations of the definition of terms in these agreements the accruals made by management in this regard may be significantly different from those determined by the Company's joint venture partners. The effect on the financial statements resulting from such adjustments, if any, will be reflected prospectively.

h) Future income taxes

The liability method is used in accounting for income taxes. Under this method, future tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities, and measured using substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse. Where uncertainty exists relating to the ability to utilize a tax asset, a valuation allowance is recorded.

i) Cash and cash equivalents

Cash and cash equivalents include cash, short term investments and all highly liquid investments purchased with an original maturity of three months or less.

j) Stock based compensation plan

The company uses the fair value method of accounting for stock options awarded to directors, officers and stockholders. Compensation expense is recorded over the vesting period using the estimated fair value of the option on the grant date. Consideration paid on the exercise of stock options is recorded as share capital.

k) Per share amounts

Basic earnings (loss) per common share are computed by dividing earnings (loss) by the weighted average number of common shares outstanding for the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options and other dilutive instruments, in accordance with new standards approved by the Canadian Institute of Chartered Accountants.

l) Foreign currency translation

Transaction amounts denominated in foreign currencies are translated into their Canadian dollar equivalents at exchange rates prevailing at the transaction dates. Carrying values of the monetary assets and liabilities reflect the exchange rates at the balance sheet date. Gains and losses on translation or settlement are included in determination of net income for the current year.

m) License fee

License fee relates to patent rights of certain lateral drainhole drilling technology. Commencing in 2005 this license fee was being amortized over the remaining life of the patent (6 years). If the license fee is determined not to have value, it will be written off in the period the determination is made.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2006 and 2005

2. Summary of Significant Accounting Policies - Continued

n) Research and development

The Company is involved in the research, development and ultimate production of oil field tools. To date, all direct and indirect costs associated with the development of these tools have been expensed as incurred. The Company will commence capitalization and deferral of these costs once technological feasibility is established and criteria for deferral are met. The Company has completed the Alpha test phase of the project and is currently seeking development partners through its subsidiary Reach Energy Innovations.

Investment tax credits are accrued when qualifying expenditures are made and there is reasonable assurance that the credits will be realized. The Company accounts for the investment tax credits using the cost reduction method.

3. Property and Equipment

	December 31, 2006			December 31, 2005		
	Cost	Accumulated Depletion and Amortization	Net Book Value	Cost	Accumulated Depletion and Amortization	Net Book Value
Petroleum and natural gas properties	\$ 6,003,487	\$ 2,147,011	\$ 3,856,476	\$ 3,546,040	\$ 1,255,821	\$ 2,290,219
Furniture and Equipment	132,371	77,169	55,202	98,236	58,748	39,488
	\$ 6,135,858	\$ 2,224,180	\$ 3,911,678	\$ 3,644,276	\$ 1,314,569	\$ 2,329,707

No general and 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, 2006 and determined that there was no impairment of costs requiring a write down in either of its cost centres.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2006 and 2005

4. Asset Retirement Obligations

At the date of completion of drilling and testing, the Company identified obligations related to oil and gas properties and records a liability equal to the present value of expected future assets retirement obligations. The total future ARO was estimated by management based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods. The Company has estimated the net present value of its total ARO to be \$149,505 as at December 31, 2006 based on a total future liability of \$249,600 and incorporated the Company's credit-adjusted risk-free interest rate of 7.5%. These payments are expected to be made over the next 9 years.

The following table reconciles the company's asset retirement obligations:

	<u>2006</u>
Asset retirement obligation, beginning of year	\$ 117,021
New liabilities incurred	24,605
Liabilities settled	-
Accretion expense	7,879
Asset retirement obligation, end of year	<u>\$ 149,505</u>
	<u>2005</u>
Asset retirement obligation, beginning of year	\$ 97,344
New liabilities incurred	-
Liabilities settled	-
Accretion expense	19,677
Asset retirement obligation, end of year	<u>\$ 117,021</u>

5. License

	<u>2006</u>	<u>2005</u>
License fee	70,000	70,000
Accumulated amortization	(28,823)	(18,529)
	<u>41,177</u>	<u>51,471</u>

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2006 and 2005

6. Bank Loan

The Company has a \$2,200,000 (2005 - \$Nil) revolving operating demand loan, of which \$1,107,224 (2005 - Nil) plus accrued interest, has been drawn at December 31, 2006. Interest is calculated at the bank's prime rate plus 1.0%.

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.

On September 15, 2005 Emerald Bay entered into an agreement with Toscana Capital Corporation and its financial partner Toscana GP Capital Inc. and obtained a \$2,000,000 bridge financing credit facility used to repay all credit facilities at the Alberta Treasury Branches and provide working capital. The loan bore interest at the rate of 12% per annum. The facility, was repaid in full January 3, 2006 and was secured against the assets of the Corporation. Fees totalling \$40,000 were paid in relation to this financing.

7. Due From Related Parties and Related Party Transactions

a) The following amounts are due by related parties:

	Dec 31, 2006	Dec 31, 2005
Due from related party		
Note receivable from officer (i)	\$ 218,500	\$ 218,500
Fair value allowance	(143,830)	-
	\$ 74,670	\$ 218,500

- (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 Corporation has provided an allowance down to the estimated value of the underlying security.

b) Except as disclosed elsewhere in the financial statements, the Company was involved in the following related party transactions for the year ended December 31, 2006.

- (i) Directors and officers, have charged the Company \$212,630 (2005 - \$194,800) for professional and administrative services.
- (ii) A law firm in which a director is a partner has charged the Company \$10,210 (2005 - \$60,745) in legal fees.
- (iii) A company owned 100% by a director has charged the Company \$222,000 (2005 - \$220,215) in consulting fees.

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

December 31, 2006 and 2005

7. Due From Related Parties and Related Party Transactions - Continued

- (iv) A company owned and controlled by a director has charged the Company \$50,847 (2005 - \$51,200).

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.

8. Equity Instruments

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

- b) Issued

Common shares issued and issuable for cash	December 31, 2006	
	Number of Shares	Amount
Balance, beginning of year	27,637,277	\$ 5,295,629
Warrants exercised	266,000	84,520
Subscription receivable		34,988
Tax effect of flow-thru share announcement		(686,000)
Balance, end of year	27,903,277	4,729,137
Warrants outstanding beginning of year	8,368,278	400,062
Warrants exercised	(266,000)	(18,020)
Warrants expired	(1,667,778)	(38,328)
Balance, end of year	6,434,500	343,714
Equity instruments balance December 31, 2006		\$ 5,072,851

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2006 and 2005

8. Equity Instruments – Continued

b) Issued - continued

Common shares issued and issuable for cash	December 31, 2005	
	Number of Shares	Amount
Balance, beginning of year	11,708,304	\$ 1,949,425
Private Placement (i)	3,000,000	600,000
Less value ascribed to warrants		(150,000)
Private Placement (ii)	2,755,556	620,000
Less value ascribed to warrants		(18,462)
Short form offering (iii)	7,256,750	2,000,000
Less value ascribed to warrants		(155,782)
Private placement (iv)	2,916,667	875,000
Subscription receivable		(34,988)
Share issue costs		(389,564)
Balance, end of year	27,637,277	5,295,629
Warrants outstanding beginning of year	1,593,798	42,400
Warrants issued (i)	3,160,000	154,720
Warrants issued (ii)	1,377,778	18,462
Warrants issued (iii)	3,540,500	207,015
Warrants issued (iv)	290,000	19,865
Warrants expired	(1,593,798)	(42,400)
Balance, end of year	8,368,278	400,062
Equity instruments balance December 31, 2005		\$ 5,695,691

- (i) On February 18, 2005, the Company completed a private placement of 3,000,000 units at an issued price of \$0.20 per unit, for consideration of \$600,000. Each unit consists of one common share and one share purchase warrant that may be exercised to acquire additional common shares at \$0.25 per share at any time in the two years following the closing of the private placement. All of the common shares issued pursuant to the private placement are subject to a 4 month hold period. 1,757,500 units of the private placement were acquired by directors and officers of the Company. The Company incurred issuance costs of \$39,095 cash and issued 160,000 agent warrants which may be exercised to acquire additional common shares at \$0.25 per share for a one year period. The compensation expense incurred in relation to the issuance of the agent warrants is \$4,720.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2006 and 2005

8. Equity Instruments - Continued

- (ii) On June 8, 2005, the Company completed a private placement of 2,755,556 units at an issued price of \$0.225 per unit, for consideration of \$620,000. Each unit consists of one common share and one-half of one share purchase warrant that may be exercised to acquire additional common shares at \$0.40 per share at any time in the twelve months following the closing of the private placement. All of the common shares issued pursuant to the private placement are subject to a 4 month hold period. The Company incurred issuance costs of \$18,375 cash.
- (iii) On December 19, 2005, the Company completed a Short Form Offering of an aggregate of 3,540,500 units and 3,716,250 flow-through shares for gross proceeds of \$2,000,000 (the maximum amount under this Offering). Units were priced at \$0.25 per unit and flow-through common shares were priced at \$0.30 per flow-through common share. Each unit consists of one (1) common share and one (1) warrant. Each full warrant entitles the holder to acquire one (1) common share at a price of \$0.35 for a period of twelve months from the date of issue or at a price of \$0.45 for an additional period of twelve months thereafter. A total of 2,809,584 common shares issued pursuant to the offering were subject to a four month hold period expiring on April 20, 2006. Union Securities Ltd. received a commission equal to 8% of the gross proceeds received by Emerald Bay pursuant to the Offering. In addition, Emerald Bay paid Union a corporate finance fee of \$25,000. Union and its sub agents also received agent's options to acquire an aggregate of 725,675 units (same unit terms as described above), at a price of \$0.25 per unit for a period of 18 months from the date of issue. The compensation expense incurred in relation to the issuance of the agent options is \$51,233.
- (iv) On December 29, 2005, the Company completed a private placement of 2,916,667 flow-through common shares at a price of \$0.30 per share for aggregate consideration of \$875,000. All of the shares issued pursuant to the private placement were subject to a four month hold period. Finder's fees totaled an aggregate of \$69,600. Emerald Bay also issued an aggregate of 290,000 finder's fees warrants, each warrant entitling the holder to acquire one common share in Emerald Bay at a price of \$0.30 for a period of twelve months from the date of issue. The compensation expense incurred in relation to the issuance of the agent options is \$19,865.

The assumptions for the value of the warrants are as follows:

Volatility	55%
Term	varies from 1 – 2 years
Annual dividend	0%
Discount rate	varies from 3 – 3.4%

- Subsequent to year end, 2,894,000 warrants exercisable at \$0.25 per common share expired without being exercised.
- The company raised \$1,989,875 from flow-thru common shares in 2005, the tax effect of the flow-thru shares was recorded in 2006 for a value of \$686,000.

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

December 31, 2006 and 2005

8. 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 exercise price of each option equals the market price of the Company's shares on the date of grant. Stock options vest annually over a 3-year period from the date of grant and expire 5 years after the date of grant. Stock options granted in 2005 vest immediately.

	December 31, 2006		December 31, 2005	
	Number of options	Weighted average exercise price	Number of options	Weighted Average Exercise price
Stock options, beginning of year	1,179,904	\$ 0.27	842,904	\$ 0.27
Granted	1,250,000	0.25	650,000	0.25
Expired			(313,000)	(0.27)
Stock options outstanding, end of year	2,429,904	\$ 0.26	1,179,904	\$ 0.27
Exercisable, end of year	2,288,237	\$ 0.26	1,003,306	\$ 0.26

The stock options outstanding as at December 31, 2006 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>
\$0.19	104,904	.9	\$ 0.19	104,904	\$ 0.19
\$0.25	1,900,000	3.9	0.25	1,900,000	0.25
\$0.32	425,000	2.3	0.32	283,333	0.32
	2,429,904	3.5	\$ 0.26	2,288,237	\$ 0.26

The stock options outstanding as at December 31, 2005 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>
\$0.19	104,904	1.9	\$ 0.19	104,904	\$ 0.19
\$0.25	650,000	4.5	0.25	650,000	0.25
\$0.32	425,000	3.3	0.32	248,402	0.32
	1,179,904	3.8	\$ 0.27	1,003,306	\$ 0.26

d) Diluted earnings (loss) per share

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

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2006 and 2005

9. Contributed Surplus

On January 16, 2006 the Company granted 1,250,000 stock options at a price of \$0.25 per share, vesting immediately and a 5 year term. The Company recorded compensation expense when stock options were issued to employees, as disclosed in Note 7(c).

The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (Nil), expected volatility (55%), risk-free interest rate of (3.4%), and weighted average life of 5 years. The estimated value of \$180,945 (2005 - \$85,710) was for the options that vested in the year with a corresponding credit to contributed surplus. In 2006 \$38,328 was added to contributed surplus for warrants that expired during the year.

10. Income Taxes

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

	2006	2005
Combined tax rate	34.49%	37.62%
Expected income tax provision at statutory rate	\$ (358,545)	\$ (324,777)
Non-deductible crown charges	70,976	128,420
Resource allowance	(26,423)	(113,903)
Alberta royalty adjustments	(38,743)	(47,003)
Non-deductible stock based compensation(Note 8)	62,408	-
Investment tax credits	-	6,764
Rate change	(24,577)	22,743
Valuation allowance	-	374,000
Other	7,909	(46,244)
Future income tax provision	\$ (306,000)	\$ (0)

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

	2006	2005
Cumulative Canadian Oil and Gas Property Expenses (COGPE)	\$ 225,000	\$ 226,000
Cumulative Canadian Development Expenses (CDE)	929,000	929,000
Cumulative Canadian Exploration Expenses (CEE)	516,000	73,000
Foreign Exploration and Development Expenses (FEDE)	192,000	213,000
Undepreciated Capital Cost (UCC)	208,000	174,000
Share issue costs	254,000	381,000
Scientific Research and Experimental Development (SR&ED)	409,000	791,000
Attributed Canadian Royalty Income (ACRI)	1,567,000	1,387,000
Non-capital losses	798,000	559,000

Emerald Bay Energy Inc.
Notes To Financial Statements

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10. Income Taxes – Continued

These pools are deductible from future income at rates prescribed by the Canadian Income Tax Act.

The components of the Company's future income tax asset (liability) are a result of the origination and reversal of temporary differences and are comprised of the following:

Nature of temporary differences	2006	2005
Property and equipment, ARO, License Fee	\$ (502,600)	\$ (218,000)
Share issue costs	73,500	128,000
Scientific Research and Experimental Development	118,500	181,000
Investment tax credits	147,500	167,000
Attributed Canadian royalty income	156,700	159,000
Loss carry-forward	231,400	188,000
Valuation allowance	(605,000)	(605,000)
Future income tax liability	\$ (380,000)	\$ -

11. Contingencies

In 2005, an oilfield service provider commenced legal action against the Company relating to the loss of a tool in the well bore of one of the Company's wells claiming total damages of \$193,121. As a result of this incident the Company has counterclaimed for \$760,000 plus additional damages. In the opinion of management, the outcome of this action is not determinable at this time.

Emerald Bay Energy Inc.
Notes To Financial Statements

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12. Segmented Information

- (a) The Company's activities include oil and gas production and development of certain lateral drainhole drilling technology. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

<u>2006</u>	Oil & gas production	Lateral drainhole drilling technology	Total
Petroleum and natural gas sales	\$ 2,708,995	\$	\$2,708,995
Interest revenue	\$ 8,315	\$	\$ 8,315
Depletion, amortization and accretion	\$ 917,490	\$ 10,294	\$ 927,784
Interest expense	\$ 33,745	\$	\$ 33,745
Fair value allowance	\$ 143,830	\$	\$ 143,830
Income tax recovery	\$ 306,000	\$	\$ (306,000)
Segment loss	\$ (733,271)	\$ (292)	\$ (733,563)
Segment assets	\$ 5,349,436	\$ 41,177	\$ 5,390,613
Capital expenditures	\$ 2,466,977	\$	\$ 2,466,977
<u>2005</u>	Oil & gas production	Lateral drainhole drilling technology	Total
Petroleum and natural gas sales	\$ 2,320,876	\$	\$2,320,876
Interest revenue	\$ 6,610	\$	\$ 6,610
Depletion, amortization and accretion	\$ 506,430	\$ 10,294	\$ 516,724
Interest expense	\$ 90,611	\$	\$ 90,611
Income tax recovery	\$ -	\$	\$ -
Segment loss	\$ (683,520)	\$ (179,790)	\$ (863,310)
Segment assets	\$ 6,653,870	\$ 51,471	\$6,705,341
Capital expenditures	\$ 759,998	\$	\$ 759,998

Company's oil and gas production is further split into geographical segments: Canada and the United States of America ("US"). The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

Emerald Bay Energy Inc.
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12. Segmented Information -- Continued

Description – Dec 31, 2006	Canada	US	Total
Petroleum and natural gas sales	\$ 2,587,556	\$ 121,439	\$ 2,708,995
Oil & gas production assets	\$ 3,421,694	\$ 489,984	\$ 3,911,678
License	\$ 41,177		\$ 41,177

Description – Dec 31, 2005	Canada	US	Total
Petroleum and natural gas sales	\$ 2,261,836	\$ 59,040	\$ 2,320,876
Oil & gas production assets	\$ 2,090,719	\$ 238,988	\$ 2,329,707
License	\$ 51,471		\$ 51,471

13. Accounts and Cash Call Receivables

	2006	2005
Accounts receivable	343,933	762,384
Cash call receivables	655,168	52,689
	<u>999,101</u>	<u>815,073</u>

14. Comparative Figures

Certain of the prior year's figures have been reclassified to conform with current presentation.