



Emerald Bay Energy

**Emerald Bay Energy Inc.
Financial Statements
For the nine months ended
September 30, 2006
(Prepared by Management - Unaudited)**

	Contents
Note to Shareholders	2
Financial Statements	
Balance Sheets	3
Statements of Operations and Deficit	4
Statements of Cash Flows	5
Notes to Financial Statements	6 - 11

UNAUDITED INTERIM FINANCIAL STATEMENTS

In Accordance with National Instrument 51-102 released by the Canadian Securities Administrators, the Company Disclosed that its auditors have not reviewed the unaudited financial statements for the period ended September 30, 2006.

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

	September 30	December 31
	2006	2005
		Audited
Assets		
Current		
Cash and cash equivalents	\$ 121,521	\$ 3,203,638
Short term investments	65,560	64,060
Accounts receivable	913,544	815,073
Prepaid expenses and deposits	12,386	2,655
	1,113,011	4,085,426
Due from related parties	218,500	218,500
Property and equipment (Note 4)	2,676,587	2,329,707
License	43,751	51,471
Deposits	20,237	20,237
	\$ 4,072,086	\$ 6,705,341

Liabilities and Shareholders' Equity

Current

Bank loan (Note 5)	\$ 350,000	\$ -
Note payable (Note 6)	-	2,000,000
Accounts payable and accrued liabilities	712,245	1,191,735
	1,062,245	3,191,735
Asset retirement obligation	122,930	117,021
	1,185,175	3,308,756

Contingencies

Shareholders' equity

Share capital (Note 4(b))	5,757,357	5,695,691
Contributed surplus	357,334	150,351
Deficit	(3,227,780)	(2,449,457)
	2,886,911	3,396,585
	\$ 4,072,086	\$ 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
Prepared by Management - Unaudited

	For the three months ended		For the nine months ended	
	Sept 30 2006	Sept 30 2005	Sept 30 2006	Sept 30 2005
Revenue				
Petroleum and natural gas sales	\$ 675,409	\$ 392,840	\$ 2,212,363	\$ 1,118,359
Royalties	(143,329)	(93,205)	(615,779)	(251,168)
Alberta Royalty Tax Credits	-	30,363	-	30,363
	<u>532,080</u>	<u>329,998</u>	<u>1,596,584</u>	<u>897,554</u>
Expenses				
Operating	149,759	58,566	492,654	185,701
General and administrative	304,231	259,866	982,725	901,021
Stock based compensation	5,783	6,463	175,162	79,246
Research and development	-	37,423	-	177,710
Depletion, depreciation and accretion	231,068	96,162	700,961	322,451
Interest	7,529	5,932	25,032	22,222
	<u>698,370</u>	<u>464,412</u>	<u>2,376,534</u>	<u>1,688,351</u>
Loss from operations	<u>(166,290)</u>	<u>(134,414)</u>	<u>(779,950)</u>	<u>(790,797)</u>
Other income				
Interest	<u>1,627</u>	<u>1,795</u>	<u>1,627</u>	<u>1,795</u>
Loss for the period	<u>(164,663)</u>	<u>(132,619)</u>	<u>(778,323)</u>	<u>(789,002)</u>
Deficit, beginning of period	<u>(3,063,117)</u>	<u>(2,242,530)</u>	<u>(2,449,457)</u>	<u>(1,586,147)</u>
Deficit, end of period	<u>\$ (3,227,780)</u>	<u>\$(2,375,149)</u>	<u>\$ (3,227,780)</u>	<u>\$ (2,375,149)</u>
Loss per common share basic and diluted(Note 5(d))	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>	<u>\$ (0.05)</u>
Weighted average number of shares	<u>27,903,277</u>	<u>17,463,860</u>	<u>27,857,189</u>	<u>17,463,860</u>

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 2006	Sept 30 2005	Sept 30 2006	Sept 30 2005
Cash flows from operating activities				
Loss for the period	\$ (164,663)	\$ (132,619)	\$ (778,323)	\$ (789,002)
Adjustments for:				
Depletion, amortization and accretion	228,494	96,161	693,240	322,451
Amortization of license fee	2,574	-	7,721	-
Stock option expense	37,604	-	206,983	72,841
	<u>104,009</u>	<u>(36,458)</u>	<u>129,621</u>	<u>(393,710)</u>
Changes in non-cash operating balances				
Accounts receivable	(579,486)	(204,414)	(98,471)	(210,714)
Prepaid expenses and deposits	(2,550)	3,093	(9,731)	35,522
Accounts payable	(426,221)	(782,749)	(389,990)	(981,066)
Accrued liabilities	-	-	(89,500)	(34,500)
	<u>(1,008,257)</u>	<u>(984,070)</u>	<u>(587,692)</u>	<u>(1,190,758)</u>
Cash flows from financing activities				
Bank loan advances (repayments)	350,000	(352,500)	350,000	(360,000)
Repayment of note payable	-	1,670,000	(2,000,000)	1,670,000
Related party advances (repayments)	-	(1,643)	-	(17,931)
Issuance of share capital, net of costs	(31,821)	4,363	61,666	1,150,934
	<u>318,179</u>	<u>1,320,220</u>	<u>(1,588,334)</u>	<u>2,443,003</u>
Cash flows from investing activities				
Purchases of property and equipment	198,252	89,391	(1,034,212)	(518,913)
Increase (decrease) in cash and equivalents				
	(387,817)	389,083	(3,080,617)	339,622
Cash and equivalents, beginning of period	574,898	48,699	3,267,698	98,160
Cash and equivalents, end of period	\$ 187,081	\$ 437,782	\$ 187,081	\$ 437,782

Cash and equivalents, end of period

Cash and cash equivalents	\$ 121,521	\$ 437,782
Short term investments	65,560	-
	<u>\$ 187,081</u>	<u>\$ 437,782</u>

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, 2006

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 drainhole 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.

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

September 30, 2006

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.

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

September 30, 2006

2. Summary of Significant Accounting Policies - Continued

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.

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 short-term investments

Cash and short-term investments include bank balances and all highly liquid instruments purchased with an original maturity of three month 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) License fee

License fee relates to patent rights of certain lateral drainhole drilling technology. Commencing in 2003 this license fee is now being amortized over a period of 6 years.

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

September 30, 2006

3. Property and Equipment

September 30, 2006

	<u>Cost</u>	<u>Accumulated Depletion and Depreciation</u>	<u>Net Book Value</u>
Petroleum and natural gas properties	\$ 4,546,518	\$ 1,929,348	\$ 2,617,168
Office furniture and other	<u>131,971</u>	<u>72,552</u>	<u>59,419</u>
	<u>\$ 4,678,489</u>	<u>\$ 2,001,901</u>	<u>\$ 2,676,587</u>

December 31, 2005

	<u>Cost</u>	<u>Accumulated Depletion and Depreciation</u>	<u>Net Book Value</u>
Petroleum and natural gas properties	\$ 3,546,040	\$ 1,255,821	\$ 2,290,219
Office furniture and other	<u>98,236</u>	<u>58,748</u>	<u>39,488</u>
	<u>\$ 3,644,276</u>	<u>\$ 1,314,569</u>	<u>\$ 2,329,707</u>

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

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

September 30, 2006

4. 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

	September 30, 2006	
	Number of Shares	Amount
Balance, beginning of year	27,637,277	\$ 5,295,629
Subscription received	-	34,988
Warrants exercised	266,000	58,500
Balance, end of period	27,903,277	5,389,117
Warrants outstanding beginning of year	8,368,278	400,062
Warrants exercised	(100,000)	(5,000)
Warrants exercised	(160,000)	(8,000)
Warrants exercised	(6,000)	(360)
Warrants expired	(1,377,778)	(18,462)
Balance, end of period	6,724,500	368,240
Equity instruments balance Sept 30, 2006		\$ 5,757,357

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

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

September 30, 2006

4. Equity Instruments

The stock options outstanding as at September 30, 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	2.1	\$ 0.19	104,904	\$ 0.19
\$0.25	1,900,000	4.6	0.25	1,900,000	0.25
\$0.32	425,000	3.0	0.32	283,333	0.32
	2,429,904	4.2	\$ 0.26	2,288,237	\$ 0.26

d) Diluted loss per share

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

5. Bank Loan

The Company has a \$2,200,000 (2005 - \$nil) revolving operating demand loan, of which \$ 350,000 (2005 - \$nil) plus accrued interest, has been drawn at September 30, 2006. Interest is calculated at the bank's prime rate plus 1.0% (2005 – nil).

Security for the loan consists of a \$10,000,000 Debenture with a floating charge over all assets.

6. Note Payable

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 interest rate was 12% per annum. The facility was repaid in full January 3, 2006 and was secured against the assets of the Corporation. Fees totaling \$40,000 were paid in relation to this financing.