

# Emerald Bay Energy Inc.

Financial Statements

**For the three and nine months ended September 30, 2012**

(expressed in Canadian dollars)

(unaudited)

# Emerald Bay Energy Inc.

## Statement of Financial Position

September 30, 2012 and December 31, 2011

(unaudited)

	September 30, 2012	December 31, 2011
	\$	\$
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	42,672	332,301
Short-term investments	48,303	49,964
Trade and other receivables	428,360	227,231
Prepaid expenses and deposits	50,437	58,805
Assets held for sale (note 8)	-	1,500,000
<b>Total current assets</b>	<b>569,772</b>	<b>2,168,301</b>
<b>Non-current assets</b>		
Due from related parties (note 14(a))	26,544	24,623
Equity investment in PRI (note 4)	455,808	459,078
Exploration and evaluation assets (note 5)	193,996	-
Property and equipment (note 6)	950,419	1,015,177
<b>Total assets</b>	<b>2,196,539</b>	<b>3,667,179</b>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Bank loan (note 10)	-	2,675,000
Accounts payable and accrued liabilities	2,558,326	2,333,903
Current portion of shareholder loan (note 11)	300,000	301,157
Current portion of long-term debt	24,345	23,345
Financial contract (note 15)	-	161,770
<b>Total current liabilities</b>	<b>2,882,671</b>	<b>5,495,175</b>
<b>Non-current liabilities</b>		
Shareholder loan (note 11)	1,200,000	-
Long-term debt	48,280	66,580
Decommissioning liabilities (note 9)	198,730	201,664
<b>Total liabilities</b>	<b>4,329,681</b>	<b>5,763,419</b>
<b>Shareholders' deficit</b>		
Share capital (note 12(b))	9,024,303	8,491,683
Warrants (note 12(c))	759,521	126,644
Contributed surplus (note 12(f))	1,062,575	1,048,656
Deficit	(12,979,541)	(11,763,223)
<b>Total shareholders' deficit</b>	<b>(2,133,142)</b>	<b>(2,096,240)</b>
<b>Total liabilities and shareholders' deficit</b>	<b>2,196,539</b>	<b>3,667,179</b>
<b>Going concern (note 1)</b>		
<b>Commitments (note 16)</b>		
<b>Subsequent events (note 18)</b>		

Approved on behalf of the Board of Directors

*Signed "Shelby D. Beattie"*

Director

*Signed "Gibson C. Scott"*

Director

The notes are an integral part of these financial statements.

# Emerald Bay Energy Inc.

## Statement of Comprehensive Loss (Income)

For the three and nine months ended September 30, 2012 and 2011

(unaudited)

	Three months ended September 30, 2012 \$	Three months ended September 30, 2011 \$	Nine months ended September 30, 2012 \$	Nine months ended September 30, 2011 \$
<b>Revenue</b>				
Petroleum and natural gas revenue	46,472	260,477	134,928	869,917
Royalties	(882)	(45,200)	5,724	(112,115)
	<b>45,590</b>	<b>215,277</b>	<b>140,652</b>	<b>757,802</b>
<b>Operating expenses</b>				
Exploration and evaluation expenditures	734	-	3,166	2,145
Production and operating expenses	39,195	141,300	157,645	485,926
Depletion, depreciation and amortization (note 6)	23,555	97,924	84,476	301,324
Share based payment expense (note 12(d))	-	79,982	-	79,982
General and administrative	281,908	270,879	889,502	858,354
	<b>345,392</b>	<b>590,085</b>	<b>1,134,789</b>	<b>1,727,731</b>
<b>Results from operating activities</b>	<b>(299,802)</b>	<b>(374,808)</b>	<b>(994,137)</b>	<b>(969,929)</b>
<b>Finance expense</b>				
Interest income	23,466	1,653	26,737	5,401
Interest expense	(47,856)	(56,450)	(135,909)	(146,447)
Foreign exchange gain (loss)	1,142	12,043	(5,019)	7,751
Shareholder loan financing expense (note 11)	-	-	(147,195)	-
Accretion of decommissioning liability (note 9)	(1,060)	(2,244)	(3,181)	(6,732)
<b>Net finance expense</b>	<b>(24,308)</b>	<b>(44,998)</b>	<b>(264,567)</b>	<b>(140,027)</b>
<b>Other income and expenses</b>				
Unrealized gain (loss) on financial contract (note 15)	-	158,707	161,770	120,675
Termination payment on financial contract (note 15)	-	-	(116,114)	-
Equity (loss) income on investment in PRI (note 4)	19,606	9,154	(3,270)	35,662
Realized oil and natural gas derivative(loss) gain (note 15)	-	32,368	-	66,415
Gain on purchase of drilling royalty credits	-	3,626	-	73,700
Gain on disposal of assets	-	370,234	-	370,234
Impairment on funds due from related party	-	(3,930)	-	(9,805)
<b>Net other income and expenses</b>	<b>19,606</b>	<b>570,159</b>	<b>42,386</b>	<b>656,881</b>
<b>Net loss and comprehensive (loss) income</b>	<b>(304,504)</b>	<b>150,353</b>	<b>(1,216,318)</b>	<b>(453,075)</b>
<b>Basic and fully diluted (loss) earnings per share (note 12(g))</b>	<b>(0.00)</b>	<b>0.00</b>	<b>(0.01)</b>	<b>(0.01)</b>
<b>Weighted average number of common shares outstanding during the period</b>	<b>102,778,552</b>	<b>79,355,959</b>	<b>97,109,267</b>	<b>72,245,166</b>

The notes are an integral part of these financial statements.

# Emerald Bay Energy Inc.

## Statement of Changes in Deficit

September 30, 2012 and 2011

(unaudited)

	Share capital	Warrants	Contributed surplus	Deficit	Total deficit
<b>Balance, January 1, 2011</b>	7,603,866	13,336	962,321	(9,786,167)	(1,206,644)
Issuance of common shares	60,000	-	-	-	60,000
Issue of flow through shares	42,625	-	-	-	42,625
Funds received pursuant to prior year private placement	540,500	-	-	-	540,500
Shares issued as consideration for lease acquisition	360,185	-	-	-	360,185
Issue of warrants	(116,229)	116,229	-	-	-
Share issue costs	(86,723)	-	6,353	-	(80,370)
Expiry of warrants	5,531	(5,531)	-	-	-
Share based payments	-	-	79,982	-	79,982
Loss for the period	-	-	-	(453,075)	(603,428)
<b>Balance, September 30, 2011</b>	8,409,755	124,034	1,048,656	(10,239,242)	(656,797)
<b>Balance, January 1, 2012</b>	8,491,683	126,644	1,048,656	(11,763,223)	(2,096,240)
Issuance of common shares	1,050,921	-	-	-	1,050,921
Issue of warrants	(534,419)	534,419	-	-	-
Exercise of finders options	23,500	-	-	-	23,500
Issuance of warrants to acquire shareholder loan	-	147,195	-	-	147,195
Expiry of warrants	48,737	(48,737)	-	-	-
Exercise of finders options	6,353	-	(6,353)	-	-
Share issue costs	(62,472)	-	20,272	-	(42,200)
Loss for the period	-	-	-	(1,216,318)	(1,216,318)
<b>Balance, September 30, 2012</b>	9,024,303	759,521	1,062,575	(12,979,541)	(2,133,142)

The notes are an integral part of these financial statements.

# Emerald Bay Energy Inc.

## Statement of Cash Flows

For the nine months ended September 30, 2012 and 2011

(unaudited)

	Nine months ended September 30, 2012	Nine months ended September 30, 2011
	\$	\$
<b>Cash (used in) provided by:</b>		
<b>Operating activities</b>		
Net loss for the period	(1,216,318)	(453,075)
Adjustments for:		
Depletion, depreciation and amortization	84,476	301,324
Accretion	3,181	6,732
Unrealized (gain) loss on financial contract	(161,770)	(72,137)
Equity loss on investment in PRI	3,270	(35,662)
Gain on disposal of assets	-	(370,234)
Share based payments	-	79,982
Shareholder loan financing expense	147,195	-
Impairment of funds due from related party	-	9,805
	<u>(1,139,966)</u>	<u>(581,802)</u>
Change in accounts receivable	(201,129)	75,857
Change in prepaid expenses and deposits	8,368	(11,013)
Change in accounts payable and accrued liabilities	173,340	(293,514)
Change in due to related party	(1,921)	16,097
	<u>(1,161,308)</u>	<u>(794,375)</u>
<b>Investing activities</b>		
Exploration and evaluation expenditures	(193,996)	-
Property and equipment expenditures	(25,833)	(77,996)
Proceeds received on disposal of oil and natural gas interests	1,500,000	595,260
Change in short-term investments	1,661	(2,748)
Change in accounts payable and accrued liabilities	51,083	104,172
	<u>1,332,915</u>	<u>618,688</u>
<b>Financing activities</b>		
Proceeds from issuance of common shares, net of issue costs	707,564	-
Exercise of finders options	23,500	820,315
Receipt of bank loan	-	3,475,000
Repayment of bank loan	(2,675,000)	(4,075,000)
Receipt of shareholder loan	1,500,000	-
Repayment of long term debt	(17,300)	(16,471)
Change in working capital	-	60,000
	<u>(461,236)</u>	<u>263,844</u>
<b>Change in cash</b>	<b>(289,629)</b>	<b>88,157</b>
<b>Cash, beginning of period</b>	<b>332,301</b>	<b>38,334</b>
<b>Cash, end of period</b>	<b>42,672</b>	<b>126,491</b>
<b>Non-cash transactions</b>		
Property and equipment acquired through shares issued	-	42,625
Fair value of agent options	20,272	6,353

The notes are an integral part of these financial statements.

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three and nine months ended September 30, 2012**

(unaudited)

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

Emerald Bay Energy Inc. (the "Company") was incorporated under the Business Corporations Act of Alberta on May 9, 1997 and is listed on the TSX Venture exchange. The Company is engaged in the exploration for and development of petroleum and natural gas properties principally in Alberta and Texas and is developing a lateral drilling technology. The Company is listed on the TSX Venture Exchange under the symbol "EBY.V". The Company's registered head office is located at #1A, 4015 – 1 Street South East, Calgary, Alberta, Canada T2G 4X7.

At September 30, 2012, the Company had not yet achieved profitable operations, had accumulated a deficit of \$12,979,541 since its inception (December 31, 2011 - \$11,763,223) and had a working capital deficiency of \$2,012,900 (December 31, 2011 - \$3,165,104) (defined as current assets less current liabilities), 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. Any adjustments necessary to the financial statements if the Company ceases to be a going concern could be material.

During the nine months ended September 30, 2012, management of the Company completed certain transactions to increase working capital and repay the Revolving Loan and the Non-revolving Loan (note 8 and note 12(b)).

The policies applied in these financial statements are based on IFRS issued and outstanding as of November 29, 2012 the date the Board of Directors approved the statements.

## **2 Basis of presentation**

These interim financial statements follow the same accounting policies and methods of application as the most recent annual financial statements.

For the purposes of calculating income taxes during interim period, the Company utilizes estimated annualized income tax rates.

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three and nine months ended September 30, 2012**

(unaudited)

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# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three and nine months ended September 30, 2012**

(unaudited)

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## **3 Recent accounting pronouncements**

The Company has reviewed the new and revised accounting pronouncements that have been issued but are not yet effective and determined that the following may have an impact on the Company and will become effective beginning on or after January 1, 2013:

IFRS 9 – “Financial Instruments”, which is the result of the first phase of the IASB’s project to replace IAS 39 – “Financial Instruments: Recognition and Measurement”. The new standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only two classification categories: amortized cost and fair value. The adoption of this standard should not have a material impact on the Company’s financial statements.

IFRS 10 – “Consolidated Financial Statements”, which builds on existing principles and standards and identifies the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company.

IFRS 11 – “Joint Arrangements”, which establishes the principles for financial reporting by entities when they have an interest in arrangements that are jointly controlled.

IFRS 12 – “Disclosure of Interest in Other Entities”, which provides the disclosure requirements for interests held in other entities including joint arrangements, associates, special purpose entities and other off balance sheet entities.

IFRS 13 – “Fair Value Measurement”, which defines fair value, requires disclosure about fair value measurements and provides a framework for measuring fair value when it is required or permitted within the IFRS standards.

IAS 27 – “Separate Financial Statements”, which provides amendments to IAS 27 to coincide with the changes made in IFRS 10, but retains the current guidance for separate financial statements.

IAS 28 – “Investments in Associate and Joint Ventures”, which revised the existing standard and prescribes the accounting for investments and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

IFRS 7 – “Financial Instruments: Disclosures” and IAS 32 “Financial Instruments: Presentation”, provides amendments to the previously issued IFRS 7 “Financial Instruments: Disclosures” and IAS 32 “Instruments: Presentation”, to provide clarity over the current offsetting model and develop common disclosure requirements to enhance the understanding of the potential effects of offsetting arrangements. Amendments to IFRS 7 are effective on January 1, 2013 with required retrospective application and early adoption permitted. Amendments to IAS 32 are



# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2012

(unaudited)

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effective on January 1, 2014 with required retrospective application and early adoption permitted.

IAS 1 – “Presentations of Items of OCI: Amendments to IAS 1 Presentation of Financial Statements”, which provides stipulates for the amendment of the presentation of net earnings and OCI and also requires that items are grouped within OCI based on whether the items may be subsequently reclassified to profit or loss. Amendments to IAS 1 are effective for the Company beginning on January 1, 2012 with retrospective application and early adoption permitted.

## 4 Equity investment

During the year ended December 31, 2011, the Company advanced an additional \$215,906 to PRI, which was deemed to form part of the value of the Company’s net investment in PRI.

The investment in PRI as at September 30, 2012 is as follows:

	CDN \$
<b>Net investment, December 31, 2010</b>	226,272
Proportionate share of income for the period	16,900
Additional funds advanced	215,906
<b>Net investment, December 31, 2011</b>	459,078
Proportionate share of income for the period	(3,270)
<b>Net investment, September 30, 2012</b>	455,808

## 5 Exploration and evaluation assets

	E&E Assets
<b>Balance, December 31, 2011</b>	-
Additions	193,996
<b>Balance, September 30, 2012</b>	193,996

Exploration and evaluation (“E&E”) assets consist of the Company’s exploration projects which are pending the determination of proven or probable reserves. As at September 30, 2012, the Company incurred an amount of \$193,996 on E&E expenditures (December 31, 2011 - \$nil). The additions represent the acquisition of undeveloped land and drilling activity within Texas. These E&E assets will be transferred to property and equipment when technological feasibility and commercial viability have been established.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2012

(unaudited)

## 6 Property and equipment

	Oil and natural gas interests \$	Corporate and Other \$	Total \$
<b>Cost, December 31, 2010</b>	9,998,207	298,732	10,296,939
Additions	154,352	-	154,352
Transfers to assets held for sale	(4,568,178)	-	(4,568,178)
Disposal of oil and natural gas interests	(1,177,135)	-	(1,177,135)
<b>Cost, December 31, 2011</b>	4,407,246	298,732	4,705,978
Accumulated depletion, depreciation and impairment	(6,114,065)	(172,991)	(6,287,056)
Disposal of oil and natural gas interests	664,165	-	664,165
Depreciation and depletion for the year	(358,119)	(36,113)	(394,232)
Impairment of property and equipment	(356,515)	-	(356,515)
Impairment upon transfer of assets held for sale	(385,341)	-	(385,341)
Transfer of accumulated depletion, depreciation and impairment of assets held for sale	3,068,178	-	3,068,178
<b>Carrying value, December 31, 2011</b>	925,549	89,628	1,015,177
	\$	\$	\$
<b>Cost, December 31, 2011</b>	4,407,246	298,732	4,705,978
Additions	32,397	859	33,256
Disposal of decommissioning liability	(16,156)	-	(16,156)
Change in estimate of decommissioning liability	2,618	-	2,618
<b>Cost, September 30, 2012</b>	4,426,105	299,591	4,725,696
Accumulated depletion, depreciation and impairment	(3,481,697)	(209,104)	(3,690,801)
Depreciation and depletion for the period	(65,114)	(19,362)	(84,476)
<b>Carrying value, September 30, 2012</b>	879,294	71,125	950,419

During the year ended December 31, 2011, the Company transferred assets with a net book value of \$1,500,000 to assets held for sale (note 8).

During the year ended December 31, 2011, the Company disposed of various Canadian and US oil and natural gas interests with a net book value of \$512,970 for total proceeds of \$820,260. Of the total proceeds, \$595,260 was received in cash and the remaining proceeds of \$225,000 were used to reduce outstanding payables the Company had owing to the purchaser. A gain on the sale of \$377,406 was recognized as the proceeds received were greater than the carrying amount of the assets and the associated decommissioning liabilities of \$70,118.

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three and nine months ended September 30, 2012**

(unaudited)

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## **7 Impairment loss**

During the year ended December 31, 2011, due to unexpected accelerated reserve declines, the Company tested its property and equipment for impairment.

The recoverable amount of each CGU was estimated based on the higher of the value in use and the FVLCTS. The estimate of FVLCTS was determined using a discount rate of 10% percent and forecasted cash flows, with escalating prices and future development costs, as obtained from the reserve report. The prices used to estimate the FVLCTS are those used by independent industry reserve engineers.

Based on the assessment at December 31, 2011, the carrying amount of the property and equipment was determined to be \$356,515 higher than its recoverable amount, and an impairment loss was recognized.

The Company did not record an additional impairment at September 30, 2012 or reverse any previous impairment taken.

## **8 Assets held for sale**

Prior to December 31, 2011, management was committed to selling certain oil and gas assets and was actively marketing and accepting purchase proposals. Accordingly at December 31, 2011, these assets were presented as assets held for sale. The carrying value of the assets held for sale exceeded the highest purchase proposal received of \$1,500,000, and consequently an impairment of \$385,341 was recorded in the statement of comprehensive loss as at December 31, 2011. The disposition of the assets was completed on March 16, 2012 for gross proceeds of \$1,500,000, with no gain or loss recognized on the sale. The full amount of the proceeds were used to repay the Revolving Loan (note 10).

## **9 Decommissioning obligations**

The Company's decommissioning obligations result from its ownership interest in oil and natural gas assets including well sites and gathering systems. The total decommissioning obligation is estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities and the estimated timing of the costs to be incurred in future years. The Company has estimated the net present value of the decommissioning obligations to be \$198,730 as at September 30, 2012 (December 31, 2011 - \$201,664) based on an undiscounted total future liability of \$197,740 (December 31, 2011 - \$206,810). These payments are expected to be made over the next 20 years. The obligations have been calculated using an inflation rate of 2% and a discount factor, being the risk-free rate related to the liability, of 2.13% (December 31, 2011 - 2% and 2.29%, respectively).

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three and nine months ended September 30, 2012**

(unaudited)

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	<b>September 30, 2012</b>	December 31, 2011
	\$	\$
<b>Balance, beginning of period</b>	<b>201,664</b>	239,316
Disposals	<b>(16,156)</b>	(62,818)
Liabilities incurred	<b>7,423</b>	1,518
Revisions (changes in estimates)	<b>2,618</b>	14,674
Accretion	<b>3,181</b>	8,974
<b>Balance, end of period</b>	<b>198,730</b>	201,664

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## **10 Bank loan**

On June 23, 2011, the Company amended its revolving operating demand loan (the “Revolving Loan”) with a Chartered Canadian Bank (the “Lender”). Pursuant to the amendment, the maximum amount available under the Revolving Loan was reduced from \$3,000,000 to \$1,575,000. The per annum interest rate was increased from the Lender’s prime rate plus 2.00% to the Lender’s prime rate plus 3.00%. Interest continued to be calculated daily and payable monthly on the outstanding principal amount drawn. At December 31, 2011, the Company had drawn \$1,550,000 of the Revolving Loan. During the nine months ended September 30, 2012, the Company entered into an additional amending agreement whereby the Company was to reduce the Revolving Loan by \$1,500,000 through the sale of certain oil and gas assets, which the Company fulfilled (note 8), and accordingly repaid the Revolving Loan in its entirety. An amending fee of \$10,000 was paid to the Lender, and additionally, a \$50,000 payable for the previous amendment was also paid to the Lender.

On August 15, 2011, the Company amended its existing non-revolving demand loan (the “Non-revolving Loan”) to a maximum amount of \$1,775,000. Interest on the Non-revolving Loan is calculated daily and payable monthly on the outstanding principal amount at a rate per annum equal to the bank’s prime rate plus 5.00%. At December 31, 2011, the Company had drawn \$1,125,000 of the Non-revolving Loan. During the nine months ended September 30, 2012, the Company repaid the Non-revolving loan in its entirety through the acquisition of a shareholder loan (note 11). The Company incurred professional fees of approximately \$120,000 to payout the Non-revolving Loan.

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three and nine months ended September 30, 2012**

(unaudited)

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## **11 Shareholder loan**

During the year ended December 31, 2011, the Company received a shareholder loan for \$301,157. The funds received under the shareholder loan were used to provide additional working capital to the Company. Interest on the shareholder loan is calculated daily and payable monthly on the outstanding principal amount at a rate of 10% per annum. The shareholder loan was repaid in its entirety during the nine months ended September 30, 2012.

During the nine months ended September 30, 2012, the Company entered into a loan agreement (the "Loan Agreement") with a shareholder (the "Lender") whereby the Company received a \$1,500,000 loan with a maturity date of August 15, 2013. Interest on the shareholder loan is 10% per annum, payable monthly, on the outstanding principal amount and compounds monthly. Pursuant to the Loan Agreement, the Company was required to make a principal repayment in the amount of \$500,000 on or before August 15, 2012, which was amended to require a principal repayment of \$300,000 due on November 30, 2012. The Company may, at any time, repay the loan in full without notice or penalty. If the Company is in default of the requirements included in the Loan Agreement or the Lender believes the Company's ability to repay the loan is impaired, the Lender may demand repayment of the loan or accelerate the date for payment. As at September 30, 2012, the Company had accrued \$50,000 in interest.

Pursuant to the Loan Agreement, the Company has issued to the Lender 5,000,000 share purchase warrants (the "Warrants"). Each Warrant is exercisable into one common share of the Company at a price of \$0.10 per common share until the expiry date of August 15, 2013. The Warrants have been valued at \$147,195 (note 12(c)) and have been recorded as a non-cash finance expense in the statement of comprehensive loss. The proceeds of the loan were used primarily to repay the Non-revolving Loan with the remaining proceeds used for general working capital.

Security for the loan consists of a \$1,500,000 promissory note plus interest at the rate of 10% per annum, compounded monthly, a General Security Agreement in favour of the Lender to include a specific assignment of production proceeds, and security over the US assets of the Company. The Lender has required the Company to submit to them certain reports including monthly production reports.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2012

(unaudited)

## 12 Share capital

### a) Authorized

Unlimited number of common shares with voting rights

Unlimited number of preferred shares, issuable in series

### b) Issued

	Number of Common Shares	Amount \$
<b>Balance, December 31, 2010</b>	63,309,446	7,603,866
Funds received pursuant to prior year private placement	-	60,000
Shares issued as consideration for lease acquisition (i)	532,812	42,625
Private placement (ii)	13,413,701	670,685
Value of warrants issued pursuant to private placement (ii)	-	(86,967)
Private placement (iii)	6,234,000	311,700
Value of warrants issued pursuant to private placement (iii)	-	(39,677)
Fair value reallocation on expiry of warrants (note 12(c))	-	13,336
Share issue costs (iv)	-	(83,885)
<b>Balance, December 31, 2011</b>	83,489,959	8,491,683
Private placement (v)	14,240,000	712,000
Value of warrants issued pursuant to private placement (v)	-	(346,581)
Private placement (vi)	4,841,730	338,921
Value of warrants issued pursuant to private placement (vi)	-	(187,838)
Shares issued on exercise of Finders Options (note 12(e))	470,000	23,500
Fair value reallocation on exercise of Finders Options (note 12(f))	-	6,353
Fair value reallocation on expiry of warrants (note 12(c))	-	48,737
Share issue costs (v) and (vi)	-	(62,472)
<b>Balance, September 30, 2012</b>	103,041,689	9,024,303

- (i) On March 18, 2011, the Company issued 532,812 common shares with a value of \$42,625 (\$0.08 per share). The common shares were issued as consideration for the purchase of a 100% interest in an oil and gas lease in Texas.
- (ii) On April 13, 2011 and June 17, 2011, the Company completed a private placement (collectively "Placement A"), issuing 9,413,701 units and 4,000,000 units, respectively. Each unit under Placement A was issued at \$0.05 for total proceeds of \$670,685. Each unit consists of one common share of the Company (issued either as a common share or as a FTS) and one share purchase warrant ("Warrant A"). Each Warrant A entitles the holder to purchase one additional common share of the Company at \$0.10 per share, exercisable for 18 months from the original issue date. Of the total 13,413,701 units issued, 7,203,701 were issued as a FTS. The Company has allocated \$86,967 of the unit value to warrants (note 12(c)).

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three and nine months ended September 30, 2012**

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(iii) On August 19, 2011 and October 7, 2011, the Company completed a private placement issuing 4,600,000 units and 1,634,000 units, respectively ("Placement B"). Each unit under Placement B was issued at \$0.05 for total proceeds of \$311,700. Each unit consists of one common share of the Company and one share purchase warrant ("Warrant A"). Each Warrant A entitles the holder to purchase one additional common share of the Company at \$0.10 per share, exercisable for 18 months from the original issue date. The Company has allocated \$39,677 of the unit value to warrants (note 12(c)).

(iv) Pursuant to Placement A and Placement B, the Company incurred \$77,532 in cash share issue costs and under Placement A issued 470,000 finders options (the "Finders Options") valued at \$6,353 (note 12(e)).

(v) On February 17, 2012, the Company completed a private placement ("Placement C"), issuing 14,240,000 units. Each unit under Placement C was issued at \$0.05 for total proceeds of \$712,000. Each unit consists of one common share of the Company and one share purchase warrant ("Warrant B"). Each Warrant B entitles the holder to purchase one additional common share of the Company at \$0.10 per share, exercisable for 1 year from the original issue date. The Company has allocated \$346,581 of the unit value to warrants (note 12(c)).

Pursuant to Placement C, the Company incurred \$36,200 in cash share issue costs and issued 650,000 finders options (the "Finders Options") valued at \$20,272 (note 12(e)).

(vi) On July 5, 2012, the Company completed a private placement ("Placement D"), issuing 4,841,730 units. Each unit under Placement D was issued at \$0.07 for total proceeds of \$338,921. Each unit consists of one common share of the Company and one share purchase warrant ("Warrant C"). Each Warrant C entitles the holder to purchase one additional common share of the Company at \$0.10 per share, exercisable for 1 year from the original issue date. The Company has allocated \$187,838 of the unit value to warrants (note 12(c)).

Pursuant to Placement D, the Company incurred \$6,000 in cash share issue costs.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2012

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## c) Warrants

Warrants to acquire common shares outstanding at September 30, 2012 are as follows:

	Number of warrants issued and exercisable	Amount \$	Weighted average exercise price \$	Weighted average Remaining life (years)
<b>Balance, December 31, 2010</b>	13,150,000	13,336	0.12	0.34
Share purchase warrants issued (note 12(b)(ii) and (iii))	19,647,701	126,644	0.10	0.68
Expiry of warrants	(13,150,000)	(13,336)	(0.12)	(0.34)
<b>Balance, December 31, 2011</b>	19,647,701	126,644	0.10	0.41
Share purchase warrants issued (note 12(b)(v) and (vi))	19,081,730	534,419	0.10	0.48
Share purchase warrants issued (note 11)	5,000,000	147,195	0.10	0.87
Expiry of share purchase warrants	(7,503,701)	(48,737)	0.10	-
<b>Balance, September 30, 2012</b>	<b>36,225,730</b>	<b>759,521</b>	<b>0.10</b>	<b>0.47</b>

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

	<b>2012</b>	2011
Risk-free rate	<b>1.09%</b>	1.43%
Expected life	<b>1.03 years</b>	1.5 years
Expected volatility	<b>179.46%</b>	67.41%
Fair value per warrant	<b>\$0.028</b>	\$0.010

## d) Stock options

The Company established a share option plan (the "Plan") for the benefit of officers, directors, employees and consultants of the Company. Under the Plan, the number of common shares to be reserved and authorized for issuance pursuant to options granted under the Plan cannot exceed 10% of the total number of issued and outstanding shares of the Company. The term, the vesting period and the exercise price are determined at the discretion of the Board of Directors. However, the maximum option term shall not exceed five years.



# Emerald Bay Energy Inc.

Notes to the Financial Statements

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During the nine months ended September 30, 2012, there were no stock options granted, cancellations or exercises, and 300,000 stock options expired unexercised. The following table summarizes information about the Company's stock options outstanding at September 30, 2012:

	September 30, 2012		December 31, 2011	
	Number of options	Weighted Average Exercise price \$	Number of options	Weighted Average Exercise price \$
<b>Stock options, beginning of period</b>	<b>7,680,000</b>	<b>0.10</b>	4,060,000	0.14
Granted	-	-	4,925,000	0.10
Cancelled	-	-	(305,000)	-
Expired	<b>(300,000)</b>	<b>0.10</b>	(1,000,000)	0.25
<b>Stock options outstanding, end of period</b>	<b>7,380,000</b>	<b>0.10</b>	7,680,000	0.10

The total stock options outstanding at September 30, 2012 are as follows:

Exercise prices (\$)	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price (\$)
0.10	7,380,000	3.38	0.10

As at September 30, 2012 all outstanding options have vested and are exercisable.

## e) Finders Options

During the nine months ended September 30, 2012, the Company issued 650,000 Finders Options, respectively, to the those who facilitated Placement C (note 12(b)(v)) and 470,000 Finder Options issued under Placement A were exercised. Each Finders Option granted pursuant to Placement C is exercisable into one unit consisting of one common share and one common share purchase warrant ("Finder Warrant") of the Company at \$0.05 per unit. Each Finder Warrant is exercisable into one common share of the Company at \$0.10 per common share. The Finders Options expire one year from the original grant date.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2012

(unaudited)

The following table summarizes information about the Company's Finder Options outstanding at September 30, 2012:

	September 30, 2012		December 31, 2011	
	Number of options	Weighted Average Exercise price \$	Number of options	Weighted Average Exercise price \$
Finders Options, beginning of period	470,000	0.05	750,000	0.05
Exercised	(470,000)	0.05	470,000	0.05
Granted	650,000	0.05	(750,000)	(0.05)
Finders Options outstanding, end of period	650,000	0.05	470,000	0.05

The Finders Options were valued at \$20,272 and recorded as share issue costs with the offsetting credit to contributed surplus. The fair value of the Finders Options granted is estimated as at the grant date using the Black-Scholes option pricing model. The assumptions used in the calculation are noted below:

	2012	2011
Risk-free interest rate	1.12%	1.74%
Expected life	1 years	1 years
Expected volatility	176.18%	67.41%
Fair value per option	\$0.03	\$0.01

## f) Contributed surplus

	September 30, 2012	December 31, 2011
	\$	\$
Balance, beginning of period	1,048,656	962,321
Share-based payment expense	-	79,982
Finders options (note 12(e))	20,272	6,353
Finders options exercised (note 12(e))	(6,353)	-
Balance, end of period	1,062,575	1,048,656

## g) Per share data

Basic earnings per share are calculated based on the weighted average number of shares outstanding during the period. 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. All warrants, finders options, finder warrants and stock options have been excluded from the calculation of diluted shares outstanding as they would be anti-dilutive due to the loss position of the Company.

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three and nine months ended September 30, 2012**

(unaudited)

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## **13 Income tax**

Income tax expense is recognized based on management's best estimate of the weighted average annual income tax rate expected for the full financial year. The estimated average annual rate used for the nine-months ended September 30, 2012 was 25.00% (September 30, 2011 – 26.67%).

## **14 Related party transactions**

Related party transactions not disclosed elsewhere in these financial statements are as follows:

a) The following amounts are due from related parties:

	<b>September 30, 2012</b>	December 31, 2011
	\$	\$
Note receivable from officer (i)	<b>236,530</b>	231,609
Fair value allowance (ii)	<b>(216,515)</b>	(216,515)
Net note receivable	<b>20,015</b>	15,094
Advance fees (iii)	<b>6,529</b>	9,529
	<b>26,544</b>	24,623

- (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 \$23,580 at September 30, 2012 (December 31, 2011 - \$15,094).
- (ii) The fair value allowance was initially determined on December 31, 2008 based on the market value of the secured shares. During the three and nine months ended September 30, 2012, the Company did not provide an additional allowance to the estimated fair value of the 393,000 common shares held as security as the fair value was in excess of the carrying value (December 31, 2011 – allowance of \$9,805).
- (iii) During the year ended December 31, 2008, a director was advanced \$59,473 in relation to efforts to finance and advance the Company's drilling technology. At September 30, 2012 \$6,529 (December 31, 2011 - \$9,529) 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. The original repayment date of December 31, 2010 has been extended to December 31, 2012.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2012

(unaudited)

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- b) Additional related party transactions not disclosed elsewhere in these financial statements are as follows:

For the three months ended September 30:

- (i) Aggregate fees of \$40,000 (September 30, 2011 - \$nil) were charged by directors and of the Company and was recorded in the statement of comprehensive loss.
- (ii) Aggregate fees of \$9,600 (September 30, 2011 - \$17,800) 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. The total amount \$9,600 (September 30, 2011 - \$17,800) was recorded in the statement of comprehensive loss.

For the nine months ended September 30:

- (iii) Aggregate fees of \$47,500 (September 30, 2011 - \$32,500) were charged by directors of the Company and was recorded in the statement of comprehensive loss.
- (iv) Aggregate fees of \$29,400 (September 30, 2011 - \$60,275) 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. Of this amount \$29,400 (September 30, 2011 - \$41,725) was recorded in the statement of comprehensive loss and \$nil (September 30, 2011 - \$18,550) was capitalized to property and equipment.
- (v) Included in accounts payable at September 30, 2012 was \$153,213 owing to related parties of the Company (December 31, 2011 - \$37,410).

## *Key management compensation*

	September 30, 2012	December 31, 2011
	\$	\$
Compensation	284,213	362,912
Share based payments	-	60,393
Total	<u>284,213</u>	<u>423,305</u>

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.

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three and nine months ended September 30, 2012**

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## **15 Financial contract**

During 2010, the Company entered into a commodity call option effective from January 1, 2012 to December 31, 2012 at a strike price of USD \$90.00 per BBL. During the nine months ended September 30, 2012, the Company terminated the commodity call option for consideration of \$116,114 and recognized an unrealized gain of \$161,770 (September 30, 2011 – \$158,707 and \$120,675, respectively) to reverse the financial contract liability recorded at December 31, 2011.

The realized gain recorded by the Company on the commodity call option for the three and nine months ended September 30, 2012 was \$nil (September 30, 2011 – \$32,368 and \$66,415, respectively).

## **16 Commitments**

- a) Under a lease agreement ending September 30, 2014, the Company has committed to payments of \$2,771 per month for the lease of its 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 principal repayments for fiscal years 2012 through to 2015 are respectively as follows: \$23,345, \$24,688, \$26,110 and \$15,846.
- c) The Company is committed to renounce to subscribers \$321,998 and \$360,185 of expenditures that qualify as cumulative exploration expenditures (“CEE”) for Canadian income tax purposes and to incur these expenditures no later than December 31, 2011 and December 31, 2012, respectively. At September 30, 2012, the Company has incurred approximately \$88,002 (December 31, 2011 - \$88,002) as eligible flow through expenditures against the December 31, 2011 commitment.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2012

(unaudited)

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## 17 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 September 30, 2012 (\$)		
	Canada	United States	Total
Petroleum and natural gas sales	4,875	41,597	46,472
Other income	19,606	-	19,606
Depletion, depreciation and impairment	10,954	12,601	23,555
Net loss	265,683	38,821	304,504

	Three months ended September 30, 2011 (\$)		
	Canada	United States	Total
Petroleum and natural gas sales	222,400	38,077	260,477
Other income	570,159	-	570,159
Depletion, depreciation and impairment	89,183	8,741	97,924
Net loss	32,618	117,735	150,353

	Nine months September 30, 2012 (\$)		
	Canada	United States	Total
Petroleum and natural gas sales	47,302	87,626	134,928
Other income	42,386	-	42,386
Depletion, depreciation and impairment	44,170	40,306	84,476
Net loss	1,059,834	156,484	1,216,318
Evaluation and exploration assets	-	193,996	193,996
Property and equipment	886,051	84,368	950,419

	Nine months ended September 30, 2011 (\$)		
	Canada	United States	Total
Petroleum and natural gas sales	748,357	121,560	869,917
Other income	656,881	-	656,881
Depletion, depreciation and impairment	277,383	23,941	301,324
Net loss (income)	491,571	(38,496)	453,075
Property and equipment	3,217,168	123,896	3,341,064

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the three and nine months ended September 30, 2012**

(unaudited)

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## **Subsequent events**

Subsequent to September 30, 2012, the Company closed a private placement through the issuance of 29,680,000 units (the "Units") for gross proceeds of \$1,484,000 (\$0.05/Unit). Each Unit consisted of one common share of the Company and one common share purchase warrant (the "Warrant"). Each full Warrant entitles the holder to purchase one additional common share of the Company for \$0.10/common share for a period of 12 months from the issuance of the Units. The Company incurred cash share issue costs of \$123,150 and issued an aggregate of 2,463,000 finder's options to those who facilitated the private placement. Each finder's option is exercisable into one Unit of the Company on the same terms and conditions as those received by the subscribers under the private placement.