



Emerald Bay Energy

**Emerald Bay Energy Inc.
Audited Financial Statements
For the years ended December 31, 2007 and 2006**

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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, 2007 and 2006 and the statements of operations and comprehensive loss 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, 2007 and 2006 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 21, 2008

**Emerald Bay Energy Inc.
Balance Sheets**

As at December 31	2007	2006
Assets		
Current		
Cash	\$ 14,996	\$ 261,944
Short term investments	53,715	60,560
Accounts and cash call receivable (Note 14)	983,769	999,101
Prepaid expenses	43,134	17,289
	1,095,614	1,338,894
Due from related party (Note 8)	47,160	74,670
Prepaid expenses and deposits	8,783	24,194
Property and equipment (Note 4)	4,307,958	3,911,678
License (Note 6)	30,883	41,177
	\$ 5,490,398	\$ 5,390,613
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Liabilities and Shareholders' Equity		
Current		
Bank loan (Note 7)	\$ 1,325,000	\$ 1,107,224
Accounts payable and accrued liabilities	2,306,683	1,494,430
	3,631,683	2,601,654
Future tax liability (Note 11)	-	380,000
Asset retirement obligations (Note 5)	139,043	149,505
	3,770,726	3,131,159
Going concern assumption (Note 2)		
Contingencies (Note 12)		
Commitments (Note 15)		
Shareholders' equity		
Equity instruments (Note 9(b))	4,729,136	5,072,851
Contributed surplus (Note 10)	736,153	369,623
Deficit	(3,745,617)	(3,183,020)
	1,719,672	2,259,454
	\$ 5,490,398	\$ 5,390,613

"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 Comprehensive Loss and Deficit

For the years ended December 31	2007	2006
Revenue		
Petroleum and natural gas sales	\$ 2,350,396	\$ 2,708,995
Royalties	(482,792)	(749,817)
Alberta Royalty Tax Credits	-	107,338
	<u>1,867,604</u>	<u>2,066,516</u>
Expenses		
Operating	567,433	635,854
General and administrative	1,173,123	1,191,944
Stock based compensation	22,815	180,945
Research and development	-	292
Depletion, amortization and accretion	852,382	927,784
Interest	180,925	33,745
Fair value allowance (Note 8 a) (ii)	27,510	143,830
Interest income	(13,987)	(8,315)
	<u>2,810,201</u>	<u>3,106,079</u>
Loss from operations	<u>(942,597)</u>	<u>(1,039,563)</u>
Income tax recovery (Note 11)		
Future	<u>380,000</u>	<u>306,000</u>
Net loss and comprehensive loss for the year	<u>(562,597)</u>	<u>(733,563)</u>
Deficit, beginning of year	<u>(3,183,020)</u>	<u>(2,449,457)</u>
Deficit, end of year	<u>\$ (3,745,617)</u>	<u>\$ (3,183,020)</u>
Loss per common share (Note 9(d))		
Basic and diluted	<u>\$ (0.02)</u>	<u>\$ (0.03)</u>
Weighted average number of common shares outstanding basic and diluted		
	<u>27,903,277</u>	<u>27,868,806</u>

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

2007

2006

Cash flows from operating activities

Loss for the year	\$ (562,597)	\$ (733,563)
Adjustments for:		
Depletion, amortization and accretion	842,088	917,490
Amortization of license fee	10,294	10,294
Fair value allowance	27,510	143,830
Future income tax	(380,000)	(306,000)
Stock based compensation	22,815	180,945
	<u>(39,890)</u>	<u>212,996</u>

Changes in non-cash operating balances

Accounts and cash calls receivable	(43,181)	(184,028)
Prepaid expenses and deposits	(16,834)	(5,791)
Accounts payable and accrued liabilities	218,741	(309,895)
	<u>118,836</u>	<u>(286,718)</u>

Cash flows from financing activities

Bank loan	217,776	1,107,224
Repayment of note payable	-	(2,000,000)
Related party advances	58,513	-
Issuance of share capital, net of costs	-	101,487
	<u>276,289</u>	<u>(791,289)</u>

Cash flows from investing activities

Purchases of property and equipment	(1,892,593)	(2,466,977)
Disposition of property interest	650,162	-
Accounts payable	593,513	599,790
	<u>(648,918)</u>	<u>(1,867,187)</u>

Decrease in cash and equivalents

	(253,793)	(2,945,194)
Cash and cash equivalents, beginning of year	<u>322,504</u>	<u>3,267,698</u>

Cash and cash equivalents, end of year

	\$ 68,711	\$ 322,504
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Cash and cash equivalents, end of year

2007

2006

Cash	\$ 14,996	\$ 261,944
Short term investments	53,715	60,560
	<u>\$ 68,711</u>	<u>\$ 322,504</u>

Supplemental cash flow information

2007

2006

Interest paid	\$ 180,925	\$ 33,745
Interest received	\$ 13,987	\$ 8,315

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

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2007 and 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 drilling technology.

2. Going Concern Assumption

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities and commitments in the normal course of business. The Company has a \$2,536,069 working capital deficiency at December 31, 2007.

Management is committed to raising additional capital to meet exploration and operating obligations. While management has been successful in the past in obtaining financing, there is no assurance that sufficient funds will be raised in the future. The Company's ability to continue as a going concern is dependent upon the Company's ability to raise additional equity to meet its current working capital shortfall and provide for future operational needs. Future lateral drainhole drilling operations are dependent on successful testing results and access to additional funding.

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

3. 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.

December 31, 2007 and 2006

3. Summary of Significant Accounting Policies - Continued

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 alter the rate of depletion by more than 20%.

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.

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. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost will result in an increase or decrease to the obligation. At settlement date, the entity will settle the obligation for its recorded amount or recognize a gain or loss upon settlement.

December 31, 2007 and 2006

3. Summary of Significant Accounting Policies – Continued

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 included with production costs, as they are not material to show separately. 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 tax authorities.

f) Financial instruments

On January 1, 2007, the Company adopted CICA Handbook Section 3855 establishes standards for recognizing and measuring financial assets, financial liabilities, and non-financial derivatives. It requires that financial assets and financial liabilities, including derivatives, be recognized on the balance sheet when the Company becomes a party to the contractual provisions of the financial instrument or non-financial derivative contract. Under this standard, all financial instruments are required to be measured at fair value upon initial recognition except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as held-for-trading, available-for sale, held-to-maturity, loans or receivables, or other financial liabilities. Financial assets and financial liabilities held for-trading are measured at fair value with changes in those fair values recognized in net earnings. Financial assets held-to-maturity, loans and receivables, and other financial liabilities are measured at amortized cost using the effective interest method of amortization. Investments in equity instruments classified as available-for-sale that do not have a quoted market price in an active market are measured at cost.

Cash is designated as “held-for-trading”. Accounts receivable are designated as “loans or receivables”. The revolving operating loan and accounts payable and accrued liabilities are designated as “other liabilities”.

g) Comprehensive income (loss) and accumulated other comprehensive income (loss)

On January 1, 2007, the Company adopted CICA Handbook Section 1530 “Comprehensive Income” which consists of net earnings and other comprehensive income (“OCI”). OCI represents changes in shareholder’s equity during a period arising from transactions and changes in prices, markets, interest rates, and exchange rates. OCI includes unrealized gains and losses on financial assets classified as available-for-sale, unrealized translation gains and losses arising from self-sustaining foreign operations net of hedging activities and changes in the fair value of the effective portion of cash flow hedging instruments. The Company did not have any other comprehensive income for the year ended December 31, 2007.

December 31, 2007 and 2006

3. Summary of Significant Accounting Policies – Continued

h) 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.

i) Hedges

On January 1, 2007, the Company adopted CICA Handbook Section 3865 provides alternative treatments to Section 3855 for entities which choose to designate qualifying transactions as hedges for accounting purposes. It replaces and expands on Accounting Guideline 13 "Hedging Relationships", and the hedging guidance in Section 1650 "Foreign Currency Translation" by specifying how hedge accounting is applied and what disclosures are necessary when it is applied. The Company has elected not to apply hedge accounting to its financial instruments.

j) Accounting changes

On January 1, 2007, the Company adopted CICA Handbook Section 1506 provides expanded disclosures for changes in accounting policies, accounting estimates and corrections of errors. Under the new standard, accounting changes should be applied retrospectively unless otherwise permitted or where impracticable to determine. As well, voluntary changes in an accounting policy are to be made only when required by a primary source of GAAP or the change results in more relevant and reliable information.

k) 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. The effect of a change in tax rates on future income tax assets and liabilities is recognized in operations in the period that includes the substantive enactment date. Where uncertainty exists relating to the ability to utilize a tax asset, a valuation allowance is recorded.

l) 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.

December 31, 2007 and 2006

3. Summary of Significant Accounting Policies – Continued

m) Stock based compensation

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. Upon the exercise of the stock options, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital. The Company has not incorporated an estimated forfeiture rate for stock options that will not vest; rather the Company accounts for actual forfeitures as they occur.

n) 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. Diluted per share information is calculated using the treasury stock method that assumes any proceeds received by the Company upon the exercise of in-the-money options, plus unamortized stock-based compensation cost, would be used to buy back common shares at an average market price for the financial. Anti-dilutive options or instruments are not included in the calculation and all options and instruments are considered anti-dilutive when the Company is in a loss position.

o) 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.

p) 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.

q) 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.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2007 and 2006

3. Summary of Significant Accounting Policies - Continued

r) Future accounting changes

On December 1, 2006, the CICA issued three new accounting standards: Handbook Section 1535, Capital Disclosures, Handbook Section 3862, Financial Instruments - Disclosures, and Handbook Section 3863, Financial Instruments - Presentation. These new standards are effective January 1, 2008. Section 1535 specifies the disclosure of (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; whether the entity has complied with any capital requirements; and (iv) if it has not complied, the consequences of such non-compliance. The new Sections 3862 and 3863 replace Handbook Section 3861, Financial Instruments – Disclosure and Presentations, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. The Company is assessing the impact of these new standards on the financial statements.

The Canadian Accounting Standards Board (AcSB) has confirmed that the use of International Financial Reporting Standards ("IFRS") will be required in 2011 for publicly accountable profit-oriented enterprises. IFRS will replace Canada's current GAAP for those enterprises. These include listed companies and other profit-oriented enterprises that are responsible to large or diverse groups of stakeholders. The official changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. Companies will be required to provide comparative IFRS information for the previous fiscal year. The Company is currently evaluating the impact of adopting IFRS

4. Property and Equipment

	December 31, 2007			December 31, 2006		
	Cost	Accumulated Depletion and Amortization	Net Book Value	Cost	Accumulated Depletion and Amortization	Net Book Value
Petroleum and natural gas properties	\$ 7,192,086	\$ 2,965,447	\$ 4,226,639	\$ 6,003,487	\$ 2,147,011	\$ 3,856,476
Furniture and Equipment	170,251	98,125	72,126	132,371	77,169	55,202
	<u>\$ 7,362,337</u>	<u>\$ 3,063,572</u>	<u>\$ 4,298,765</u>	<u>\$ 6,135,858</u>	<u>\$ 2,224,180</u>	<u>\$ 3,911,678</u>

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, 2007 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, 2007 and 2006

5. 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 \$139,043 as at December 31, 2007 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 Company participated in seven new wells in Q3 & Q4 2007. The wells were not yet completed at December 31, 2007 therefore the ARO will be incurred in Q1 2008.

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

	<u>2007</u>
Asset retirement obligation, beginning of year	\$ 149,505
New liabilities incurred	-
Liabilities transferred on sale	(13,158)
Accretion expense	2,696
Asset retirement obligation, end of year	<u>\$ 139,043</u>

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

6. License

	<u>2007</u>	<u>2006</u>
License fee	70,000	70,000
Accumulated amortization	(39,117)	(28,823)
	<u>30,883</u>	<u>41,177</u>

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2007 and 2006

7. Bank Loan

The Company has a \$2,750,000 (2006 - \$2,200,000) revolving operating demand loan, of which \$1,325,000 (2006 – 1,107,224), has been drawn at December 31, 2007. 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. The Company is also required to maintain certain covenants that it is in compliance with at year end.

8. Due From Related Parties and Related Party Transactions

a) The following amounts are due by related parties:

	Dec 31, 2007	Dec 31, 2006
Due from related party		
Note receivable from officer (i)	\$ 218,500	\$ 218,500
Fair value allowance	(171,340)	(143,830)
	\$ 47,160	\$ 74,670

- (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 to the estimated fair value of the underlying security \$27,510 (2006 - \$143,830)

- 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, 2007.
 - (i) Directors and officers, have charged the Company \$266,668 (2006 - \$263,477) for services.
 - (ii) A law firm in which a director is a partner has charged the Company \$12,821(2006 - \$10,210) in legal fees.
 - (iii) An oil and gas completions, operations, geological and consulting firm owned 100% by a director has charged the Company \$241,707 (2006 - \$222,000) in consulting fees.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2007 and 2006

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

- (iv) A director was advanced fees totaling \$58,513 (2006 – Nil) in relation to efforts to finance and advance the Company’s drilling technology. There is no guarantee that such effort will be successful. If such efforts are not successful, the full balance will be repaid in 2008. The above amount is included in accounts and cash call receivable at year end.
- (v) A U.S. corporation, providing field operation services in relation to operating the company’s U.S. properties, owned and controlled by an officer and a director has charged the Company \$224,817 (2006 - \$154,056). Included in accounts receivable is \$24,601 of advances to the corporation for future expenses

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

9. 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, 2007	
	Number of Shares	Amount
Balance, beginning of year	27,903,277	\$ 4,729,136
Balance, end of year	27,903,277	4,729,136
Warrants outstanding beginning of year	6,434,500	343,714
Warrants expired	(6,434,500)	(343,714)
Balance, end of year	-	-
Equity instruments balance December 31, 2007		\$ 4,729,136

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2007 and 2006

9. Equity Instruments – Continued

b) Issued - continued

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 renoucement		(686,000)
Balance, end of year	27,903,277	4,729,136
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

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 2007 and 2006 vest immediately on issuance.

	December 31, 2007		December 31, 2006	
	Number of options	Weighted average exercise price	Number of options	Weighted Average Exercise price
Stock options, beginning of year	2,429,904	\$ 0.26	1,179,904	\$ 0.27
Granted	200,000	0.17	1,250,000	0.25
Expired	(104,904)	0.19		
Stock options outstanding, end of year	2,525,000	\$ 0.26	2,429,904	\$ 0.26
Exercisable, end of year	2,525,000	\$ 0.26	2,288,237	\$ 0.26

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2007 and 2006

9. Equity Instruments – Continued

The stock options outstanding as at December 31, 2007 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>
\$0.17	200,000	4.8	\$ 0.17	200,000	\$ 0.17
\$0.25	1,900,000	2.9	0.25	1,900,000	0.25
\$0.32	425,000	1.3	0.32	425,000	0.32
	<u>2,525,000</u>	<u>2.8</u>	<u>\$ 0.26</u>	<u>2,525,000</u>	<u>\$ 0.26</u>

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
	<u>2,429,904</u>	<u>3.5</u>	<u>\$ 0.26</u>	<u>2,288,237</u>	<u>\$ 0.26</u>

d) Diluted earnings (loss) per share

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

10. Contributed Surplus

In 2007 the Company granted 200,000 stock options (2006 - 1,250,000), at a price of \$0.17 per share (2006 - \$0.25 per share), vesting immediately with a 5 year term. The Company recorded compensation expense when stock options were issued to employees, as disclosed in Note 9(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 \$22,815 (2006 - \$180,945) was for the options that vested in the year with a corresponding credit to contributed surplus.

Contributed surplus	2007	2006
Balance outstanding, beginning of year	\$ 369,623	\$ 150,351
Stock-based compensation	22,815	180,945
Warrants expired	343,715	38,327
Balance outstanding, end of year	<u>\$ 736,153</u>	<u>\$ 369,623</u>

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2007 and 2006

11. Income Taxes

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

	<u>2007</u>	<u>2006</u>
Combined tax rate	32.12%	34.49%
Expected income tax provision at statutory rate	\$ (302,107)	\$ (358,545)
Non-deductible crown charges		70,976
Resource allowance		(26,423)
Alberta royalty adjustments		(38,743)
Non-deductible stock based compensation	7,328	62,408
Rate change	(74,621)	(24,577)
Valuation allowance	(10,600)	
Other		7,909
Future income tax recovery	\$ (380,000)	\$ (306,000)

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

	<u>2007</u>	<u>2006</u>
Cumulative Canadian Oil and Gas Property Expenses (COGPE)	\$ 172,000	\$ 225,000
Cumulative Canadian Development Expenses (CDE)	1,113,000	929,000
Cumulative Canadian Exploration Expenses (CEE)	1,534,000	516,000
Foreign Exploration and Development Expenses (FEDE)	173,000	192,000
Undepreciated Capital Cost (UCC)	246,000	208,000
Share issue costs	125,564	254,000
Scientific Research and Experimental Development (SR&ED)	409,000	409,000
Attributed Canadian Royalty Income (ACRI)	1,567,000	1,567,000
Non-capital losses	462,850	798,000

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2007 and 2006

11. 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	2007	2006
Property and equipment, ARO, License Fee	\$ (237,000)	\$ (502,600)
Share issue costs	31,000	73,500
Scientific Research and Experimental Development	102,000	118,500
Investment tax credits	167,000	147,500
Attributed Canadian royalty income	157,000	156,700
Loss carry-forward	108,000	231,400
Valuation allowance	(328,000)	(605,000)
Future income tax liability	\$ 0	\$ (380,000)

12. 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 and will have no material outflow or recovery.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2007 and 2006

13. Segmented Information

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

<u>2007</u>	Oil & gas production	LDD	Total
		\$	
Petroleum and natural gas sales	\$ 2,350,396		\$2,350,396
Interest revenue	\$ 13,987	\$	\$ 13,987
Depletion, amortization and accretion	\$ 842,088	\$ 10,294	\$ 852,382
Interest expense	\$ 180,925	\$	\$ 180,925
Fair value allowance	\$ 27,510	\$	\$ 27,510
Income tax recovery	\$ (380,000)	\$	\$ (380,000)
Segment loss	\$ (562,597)	\$	\$ (562,597)
Segment assets	\$ 4,267,882	\$ 30,883	\$ 4,298,765
Capital expenditures	\$ 1,239,638	\$	\$ 1,239,638
<u>2006</u>	Oil & gas production	LDD	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

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.
Notes To Financial Statements

December 31, 2007 and 2006

13. Segmented Information -- Continued

Description – Dec 31, 2007	Canada	US	Total
Petroleum and natural gas sales	\$ 2,197,193	\$ 153,203	\$ 2,350,396
Oil & gas production assets	\$ 3,623,051	\$ 675,714	\$ 4,298,765
License	\$ 30,883		\$ 30,883

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

14. Accounts and Cash Call Receivables

	2007	2006
Accounts receivable	520,686	343,933
Cash call receivables	463,083	655,168
	<u>983,769</u>	<u>999,101</u>

15. Commitments

Emerald Bay Energy Inc. have committed to the leasing of office premises till September 30, 2009 with future lease payments of \$75,985 owing.

16. Comparative Figures

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