Emerald Bay Energy

Emerald Bay Energy Inc.
Financial Statements
For the nine months ended
September 30, 2008
(Prepared by Management - Unaudited)

Contents

UNAUDITED INTERIM FINANCIAL STATEMENTS

In Accordance with National Instrument 51-102 released by the Canadian Securities Administrators, the Company Discloses that its auditors have not reviewed the unaudited financial statements for the period ended September 30, 2008

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

	September 30 2008	December 31 2007 Audited
Assets		
Current		
Cash	$ **83,220**	$ 14,996
Short term investments	**50,000**	53,715
Accounts receivable	**1,015,749**	983,769
Prepaid expenses	**45,004**	43,134
	1,193,973	1,095,611
Due from related parties (Note 8)	**47,160**	47,160
Prepaid expenses and deposits	**8,234**	8,783
Property and equipment (Note 4)	**4,642,225**	4,307,958
License	**23,163**	30,883
	$ **5,914,755**	$ 5,490,398
Liabilities and Shareholders' Equity		
Current		
Bank demand loan (Note 6)	$ **1,625,000**	$ 1,325,000
Accounts payable and accrued liabilities	**1,950,604**	2,306,683
	3,575,604	3,631,683
Asset retirement obligation	**99,863**	139,043
	3,675,467	3,770,726
Shareholders' equity		
Share capital (Note 5(b))	**5,525,697**	4,729,136
Contributed surplus	**762,149**	736,153
Deficit	**(4,048,558)**	(3,745,617)
	2,239,288	1,719,672
	$ **5,914,755**	$ 5,490,398

"Shelby D. Beattie" Director
Shelby D. Beattie

"Gibson C. Scott"" Director
Gibson C. Scott

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

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

	For the three months ended		For the nine months ended	
	Sept 30 2008	Sept 30 2007	**Sept 30 2008**	Sept 30 2007
Revenue				
Petroleum and natural gas sales	**$ 756,783**	$ 498,972	**$ 2,399,505**	$ 1,754,002
Royalties	**(189,315)**	(90,254)	**(501,287)**	(369,171)
	567,468	408,718	**1,898,218**	1,384,831
Expenses				
Operating	**226,390**	198,416	**590,872**	425,143
General and administrative	**320,471**	219,323	**1,012,962**	862,024
Stock option expense	**-**	-	**-**	5,595
Depletion, amortization and accretion	**116,795**	254,371	**405,333**	743,027
Interest	**36,193**	55,577	**117,045**	118,941
Allowance for bad debt	**81,196**	-	**81,196**	-
	781,045	727,687	**2,207,408**	2,154,730
Loss from operations	**(213,577)**	(318,969)	**(309,190)**	(769,899)
Other income				
Interest	**1,668**	579	**6,249**	2,182
Loss for the period before tax	**(211,909)**	(318,390)	**(302,941)**	(767,717)
Income tax				
Future income tax recovery	**-**	95,809	**-**	227,809
	-	95,809	**-**	227,809
Net loss and comprehensive loss for the period	**(211,909)**	(222,581)	**(302,941)**	(539,908)
Deficit, beginning of period	**(3,836,649)**	(3,500,347)	**(3,745,617)**	(3,183,020)
Deficit, end of period	**$ (4,048,558)**	$ (3,722,928)	**$ (4,048,558)**	$ (3,722,928)
Loss per common share basic and diluted (Note 5(d))	**$ (0.00)**	$ (0.01)	**$ (0.01)**	$ (0.02)
Weighted average number of shares	**29,820,506**	27,903,277	**29,820,506**	27,903,277

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 2008	Sept 30 2007	**Sept 30 2008**	Sept 30 2007
Cash flows from operating activities				
Net loss for the period	**$ (211,909)**	$ (222,581)	**$ (302,941)**	$ (539,908)
Adjustments for:				
Depletion, amortization and accretion	**114,221**	251,797	**397,613**	735,306
Amortization of license fee	**2,574**	2,574	**7,721**	7,721
Future income taxes	**-**	(60,808)	**-**	(192,809)
Stock option expense	**-**	-		5,595
Allowance for bad debt	**81,196**	-	**81,196**	-
Cash flow from operations	**(13,918)**	(29,018)	**183,589**	15,905
Changes in non-cash operating balances				
Accounts receivable	**106,712**	(648,772)	**(113,175)**	(125,798)
Prepaid expenses and deposits	**14,750**	(37,265)	**(1,321)**	(37,265)
Accounts payable	**260,531**	573,329	**(286,581)**	26,832
Accrued liabilities	**(69,500)**	-	**(69,500)**	(69,500)
	298,575	(141,726)	**(286,988)**	(189,826)
Cash flows from financing activities				
Bank demand loan (repayment)	**(650,000)**	400,000	**300,000**	1,617,776
Issuance of share capital, net of costs	**822,557**	-	**822,557**	-
	172,557	400,000	**1,122,557**	1,617,776
Cash flows from investing activities				
Purchases of property and equipment	**(428,352)**	(259,907)	**(771,060)**	(1,644,808)
Increase (decrease) in cash and equivalents	**42,780**	(1,635)	**64,509**	(216,858)
Cash and equivalents, beginning of period	**90,440**	107,281	**68,711**	322,504
Cash and equivalents, end of period	**$ 133,220**	$ 105,646	**$ 133,220**	$ 105,646

Cash and equivalents, end of period	**2008**	2007
Cash	**$ 83,220**	$ 55,201
Short term investments	**50,000**	50,445
	$ 133,220	$ 105,646

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

1. Basis of Presentation

The interim financial statements of Emerald Bay Energy Inc. (the “Corporation”) have been prepared in accordance with Canadian Generally Accepted Accounting Principles (“GAAP”) and are consistent with the presentation and disclosure in the audited financial statements and notes thereto for the year ended December 31, 2007. The interim financial statements contain disclosures which are supplemental to the Corporation’s annual financial statements. Certain disclosures, which are normally required to be included in the notes to the annual financial statements, have been condensed or omitted. The interim financial statements should be read in conjunction with the Corporation’s audited financial statements and notes thereof for the year ended December 31, 2007.

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 $ 2,301,434 working capital deficiency at September 30, 2008.

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. Adoption of New Accounting Policies

Financial Instruments – disclosures and Presentation

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

Comprehensive Income

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

Capital Disclosures

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

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

International Financial Reporting Standards

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

4. Property and Equipment

	September 30, 2008			December 31, 2007		
	Cost	**Accumulated Depletion and Amortization**	**Net Book Value**	Cost	Accumulated Depletion and Amortization	Net Book Value
Petroleum and natural gas properties	**$7,968,848**	**$ 3,385,738**	**$4,583,110**	$7,192,086	$ 2,965,447	$4,226,639
Furniture and Equipment	**173,742**	**114,627**	**59,115**	179,443	98,124	81,319
	$8,142,590	**$ 3,500,365**	**$4,642,225**	$7,371,529	$ 3,063,571	$4,307,958

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

The company applied the ceiling test to its petroleum and natural gas properties at December 31, 2007 and determined that there was no impairment of costs requiring a write down in either of its cost centres.

5. Equity Instruments

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

b) Issued

Common shares issued and issuable for cash

	September 30, 2008		December 31, 2007	
	Number of Shares	**Amount**	Number of Shares	Amount
Balance, beginning of period	**27,903,277**	**$4,729,136**	27,903,277	$ 4,729,136
Issued	**6,131,169**	**796,561**	-	-
Balance, end of period	**34,034,446**	**5,525,697**	27,903,277	4,729,136
Warrants outstanding beginning of period	**-**	**-**	6,434,500	343,714
Warrants expired	**-**	**-**	(6,434,500)	(343,714)
Balance, end of period	**-**	**-**	-	-
Equity instruments balance September 30, 2008		**$5,525,697**		$ 4,729,136

5. Equity Instruments - continued

c) Stock options

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

	September 30, 2008			December 31,2007		
	Number of options		**Weighted average exercise price**	Number of options		Weighted Average Exercise price
Stock options, beginning of period	**2,525,000**	**$**	**0.26**	2,429,904	$	0.26
Granted	**613,117**		**0.15**	200,000		0.17
Expired				(104,904)		0.19
Expired	**(250,000)**		**0.25**			
Stock options outstanding, end of period	**2,888,117**	**$**	**0.23**	2,525,000	$	0.26
Exercisable, end of period	**2,888,117**	**$**	**0.23**	2,525,000	$	0.26

The stock options outstanding as at September 30, 2008 are as follows:

	Options outstanding				**Options exercisable**		
Exercise prices	**Options outstanding**	**Weighted average remaining term (years)**		**Weighted average exercise price**	**Options exercisable**		**Weighted average exercise price**
$0.17	**200,000**	**3.9**	**$**	**0.17**	**200,000**	**$**	**0.17**
$0.25	**1,650,000**	**2.0**		**0.25**	**1,650,000**		**0.25**
$0.32	**425,000**	**.4**		**0.32**	**425,000**		**0.32**
$0.15	**613,117**	**1.8**		**0.15**	**613,117**		**0.15**
	2,888,117	**2.0**	**$**	**0.26**	**2,888,117**	**$**	**0.23**

d) Diluted loss per share

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

6. Bank Loan

The Company has a $3,000,000 (2007 - $3,000,000) revolving operating demand loan, of which $1,625,000 (2007 - $2,275,000) plus accrued interest, has been drawn at September 30, 2008. Interest is calculated at the bank's prime rate plus 1.25%.

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

7. Financial Instruments and Risk Management

The Corporation has the following financial instruments:

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

a) Market risk

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

b) Credit risk

The majority of the Corporation's accounts receivable are due from joint venture partners in the oil and gas industry and from purchasers of the Corporation's petroleum and natural gas production and are subject to the same industry factors such as commodity price fluctuations and escalating costs. The Corporation generally extends unsecured credit to these customers and therefore, the collection of accounts receivable may be affected by changes in economic or other conditions. Management believes risk is mitigated by the size and reputation of the companies to which they extend credit. The Corporation has not experienced any credit loss in the collection of accounts receivable in 2008.

Receivables from petroleum and natural gas marketers are normally collected on the twenty-fifth day of the month following production. Receivables related to the sale of the Corporation's oil and natural gas production are from major marketing companies. The Corporation historically has not experienced any collection issues with its petroleum and natural gas marketers.

Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Corporation attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to expenditure and issuing cash calls on large capital projects from its partners on capital projects before they commence.

Included in accounts receivable is $ 162,393 due from SemCanada Crude Company. SemCanada Crude Company entered into CCAA proceedings on July 21, 2008. The results of the CCAA proceedings are undeterminable at this time. The company has taken a 50% provision of $81,196 against this receivable.

c) Liquidity risk

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

d) Fair value of financial instruments

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

8. Due From Related Parties and Related Party Transactions

a) The following amounts are due by related parties:

	Sept 30, 2008	Dec 31, 2007
Due from related party		
Note receivable from officer (i)	**$ 218,500**	$ 218,500
Fair value allowance	**171,340)**	(171,340)
	$ 47,160	$ 47,160

(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 $47,160 (2007 - $47,160)

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 for the nine months ended September 30, 2008 $176,713 (2007 - $129,471) for services.

(ii) A law firm in which a director is a partner has charged the Company for the nine months ended September 30, 2008 $57,021 (2007 - $9,315) in legal fees.

(iii) An oil and gas completions, operations, geological and consulting firm owned 100% by a director has charged the Company for the nine months ended September 30, 2008 $118,650 (2007 - $93,280) in consulting fees.

(iv) A director was advanced fees totaling $20,961 (2007 – $27,500) 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 $76,282 (2007 - $151,276). Included in accounts receivable is $10,686 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. Capital Management

The Corporation's capital consists of shareholders' equity, bank debt and working capital. The Corporation will adjust its capital structure to manage its current and future debt, drilling programs and potential corporate acquisitions through the issuance of shares, increasing the credit facility line and adjustments to capital spending.

The Corporation's objective for managing capital is to maximize long-term Shareholder value by ensuring adequate capital to achieve the Corporation's objectives.

The Corporation monitors capital structure using non-GAAP measures, based on the ratio of net debt to annualized funds flow. The Corporation also monitors capital structure by reviewing net asset value.

The Corporation is bound by certain debt covenants. These covenants include maintaining a Working Capital Ratio of not less than 1.0 to 1.0 at all times. The Working Capital ratio for this purpose is defined as Current Assets (including the un-drawn Availability under the Credit Facility A) to Current Liabilities (excluding any current portion of Bank Debt). As at September 30, 2008, the Corporation was not in violation of any bank covenants.