



Emerald Bay Energy

Emerald Bay Energy Inc.

Financial Statements

For the three and nine months ended

September 30, 2010

(Prepared by Management – Unaudited)

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Notice to the Reader

The accompanying unaudited interim financial statements of Emerald Bay Energy Inc. for the three and nine months ended September 30, 2010 have been prepared by management and approved by the Board of Directors of the Company. These statements have not been reviewed by the Company's external auditors.

Approved on behalf of Emerald Bay Energy Inc.,

(Signed) "Shelby D. Beattie"
Director

(Signed) "Gibson C. Scott"
Director

November 29, 2010
Calgary, Alberta

Emerald Bay Energy Inc.

Balance Sheet

As at September 30, 2010 and December 31, 2009

(Unaudited - expressed in Canadian dollars)

	September 30, 2010	December 31, 2009
	\$	\$
Assets		
Current Assets		
Cash	-	142,728
Short term investments	51,450	55,864
Accounts and cash call receivable	1,498,461	970,257
Prepaid expenditures	36,108	64,212
Financial contract (note 11(c))	48,719	-
	1,634,738	1,233,061
Due from related parties (note 10(a))	55,221	63,238
Property, plant and equipment (note 6)	5,063,595	5,053,833
License	2,959	11,835
Investment in Production Resources Inc (note 5)	232,048	-
	6,988,561	6,361,967
Liabilities		
Current liabilities		
Cheques in transit	91,137	-
Bank loan (note 8)	2,925,000	2,935,019
Accounts payable and accrued liabilities	3,217,865	2,616,909
Current portion of long term debt (note 13(b))	21,768	13,079
	6,255,770	5,565,007
Long term debt (note 13(b))	95,624	67,919
Asset retirement obligation (note 7)	139,704	131,757
	6,491,098	5,764,683
Shareholders' equity		
Share capital (note 9(b))	6,434,871	5,830,596
Warrants (note 9(c))	107,614	102,083
Contributed surplus (note 9(e))	880,902	766,924
Deficit	(6,925,924)	(6,102,319)
	497,463	597,284
	6,988,561	6,361,967

Nature of operations (note 1)

Commitments (note 13)

Subsequent events (note 15)

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

Emerald Bay Energy Inc.

Statement of Loss, Comprehensive Loss and Deficit

For the three and nine months ended September 30, 2010 and 2009

(Unaudited - expressed in Canadian dollars)

	Three months ended September 30, 2010 \$	Three months ended September 30, 2009 \$	Nine months ended September 30, 2010 \$	Nine months ended September 30, 2009 \$
Revenue				
Petroleum and natural gas sales	314,816	301,107	1,087,862	1,001,987
Royalties	(55,031)	(42,068)	(191,148)	(125,609)
Interest income	8,516	1,782	10,000	3,985
	268,301	260,821	906,714	880,363
Expenses				
Operating	137,966	178,365	457,282	481,210
General and administrative	318,053	184,556	822,416	956,753
Depletion, depreciation and accretion	144,392	139,879	440,715	309,305
Stock based compensation (note 9(e))	-	-	109,560	-
Interest	53,979	41,986	117,071	101,098
Gain on sale of inventory	-	(2,629)	-	(2,629)
Foreign exchange loss	4,724	-	3,373	-
	659,114	542,157	1,950,417	1,845,737
Net operating loss	(390,813)	(281,336)	(1,043,703)	(965,374)
Other income and expenses				
Equity income (loss) of Production Resources Inc. (note 5)	14,941	-	8,879	-
Unrealized gain on financial contract (note 11(c))	1,340	-	48,719	-
Net (loss) before income tax	(374,532)	(281,336)	(986,105)	(965,374)
Future income tax recovery	-	-	162,500	336,000
Net loss and comprehensive loss for the period	(374,532)	(281,336)	(823,605)	(629,374)
Deficit, beginning of period	(6,551,392)	(4,815,930)	(6,102,319)	(4,467,892)
Deficit, end of period	(6,925,924)	(5,097,266)	(6,925,924)	(5,097,266)
Basic and diluted income (loss) per share (note 9(g))	(0.01)	(0.01)	(0.02)	(0.02)
Weighted average shares outstanding during the period	50,159,446	30,012,753	49,019,740	30,012,753

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

Emerald Bay Energy Inc.

Statement of Cash Flows

For the three and nine months ended September 30, 2010 and 2009

(Unaudited - expressed in Canadian dollars)

	Three months ended September 30, 2010 \$	Three months ended September 30, 2009 \$	Nine months ended September 30, 2010 \$	Nine months ended September 30, 2009 \$
Cash flows provided used in operating activities:				
Net income for the period	(374,532)	(281,336)	(823,605)	(629,374)
Items not affecting cash:				
Amortization of license fee	2,959	2,574	8,876	7,721
Depletion, depreciation and accretion	141,434	137,306	431,840	301,585
Stock based compensation	-	-	109,560	-
Unrealized (gain) on financial contract	(1,340)	-	(48,719)	-
Unrealized (gain) of Production Resources Inc.	(14,941)	-	(8,879)	-
Future income taxes	-	-	(162,500)	-
	(246,420)	(141,456)	(493,427)	(320,068)
Changes in non-cash working capital				
Change in accounts receivable	169,857	(20,822)	(528,204)	571,536
Change in prepaid expenditures	33,073	(8,700)	28,104	5,909
Change in accounts payable and accrued liabilities	(121,379)	31,652	565,434	(62,884)
	(164,869)	(139,326)	(428,093)	194,493
Cash flows used in investing activities				
Purchase of property and equipment	(238,411)	(176,110)	(385,912)	(816,081)
Sale of interest in subsidiary	-	-	214,500	-
	(238,411)	(176,110)	(171,412)	(816,081)
Cash flows provided by financing activities				
Private placement, net of issue costs	374,577	-	374,577	-
Receipt of related party receivable	3,248	-	8,017	-
Renunciation of flow-through benefit	-	-	-	(336,000)
Receipt (repayment) of bank loan	50,000	249,195	(10,019)	699,195
Repayment of long term debt	(5,314)	-	(11,349)	-
	422,511	249,195	361,226	363,195
Change in cash and cash equivalents	19,231	(66,241)	(238,279)	(258,394)
Cash and cash equivalents, beginning of period	(58,918)	128,137	198,592	320,290
Cash and cash equivalents, end of period	(39,687)	61,896	(39,687)	61,896

The accompanying 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, 2010

(Unaudited - expressed in Canadian dollars)

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.

These financial statements have been prepared in accordance with generally accepted accounting principles applicable to a going concern, which assumes that the Company will be able to meet its obligations and continue its operations for its next fiscal year. Realization values may be substantially different from carrying values as shown and these financial statements do not give effect to adjustments that would be necessary to the carrying values and classification of assets and liabilities should the Company be unable to continue as a going concern.

At September 30, 2010, the Company had not yet achieved profitable operations, had accumulated a deficit of \$6,925,924 since its inception (December 31, 2009 - \$6,102,319) and had a working capital deficiency of \$1,696,032 (December 31, 2009 - \$1,396,927) (excluding the bank loan), 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.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

2 Significant accounting policies

These unaudited interim financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”), using the same accounting policies and methods as per the annual audited financial statements for the year ended December 31, 2009. They do not include all of the disclosures required by Canadian GAAP, and should be read in conjunction with the most recent annual audited consolidated financial statements of the Company.

The results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of those to be expected for the entire year ending December 31, 2010.

3 Adoption of accounting standard

Investments

Investments in companies subject to significant influence are accounted for using the equity method. The equity method is a basis of accounting whereby the investment is initially recorded at cost and the carrying value is adjusted thereafter to include the Company’s pro-rata share of post-acquisition income or loss. The amount of the adjustment is included in the determination of net (loss) income by the Company and the investment account of the Company is also increased or decreased to reflect the Company share of capital transactions and changes in accounting policies and corrections of errors. Profit distributions received or receivable from the investments will reduce the carrying value of the investment. Investments accounted for on the equity basis are written down to their fair value when they have a loss in value that is other than a temporary decline.

4 Future accounting and reporting changes

Business Combinations, Consolidated Financial Statements and Non-controlling Interest

In January 2009, the CICA issued CICA Handbook Sections 1582: Business Combinations, Section 1601: Consolidations, and Section 1602: Non-controlling Interest. These sections replace the former CICA Handbook Section 1581: Business Combinations and Section 1600: Consolidated Financial Statements and establish a new section for accounting for a non-controlling interest in a subsidiary. CICA Handbook Section 1582 establishes standards for the accounting for a business combination, and states that all assets and liabilities of an acquired business will be recorded at fair value. Obligations for contingent considerations

Emerald Bay Energy Inc.

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For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

and contingencies will also be recorded at fair value at the acquisition date. The standard also states that acquisition-related costs will be expensed as incurred and that restructuring charges will be expensed in the periods after the acquisition date. It provides the Canadian equivalent to IFRS 3, Business Combinations (January 2008). The section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011.

CICA Handbook Section 1601 establishes standards for the preparation of consolidated financial statements.

CICA Handbook Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in the preparation of consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of IFRS IAS 27, Consolidated and Separate Financial Statements (January 2008).

CICA Handbook Sections 1601 and 1602 apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier adoption of these sections is permitted as of the beginning of a fiscal year.

All three sections must be adopted concurrently. The Company is assessing the impact of these new standards.

Equity

In August 2009, the AcSB issued amendments to CICA Handbook Section 3251: Equity as a result of issuing CICA Handbook Section 1602: Non-controlling Interests. The amendments require non-controlling interests to be recognized as a separate component of equity. The amendments apply only to entities that have adopted Section 1602. The Company is assessing the impact of these new standards.

Comprehensive Revaluation of Assets and Liabilities

In August 2009, the AcSB issued amendments to CICA Handbook Section 1625: Comprehensive Revaluation of Assets and Liabilities for consistency with new CICA Handbook Section 1582: Business Combinations. The amendments apply prospectively to comprehensive revaluations of assets and liabilities occurring in fiscal years beginning on or after January 1, 2011. The Company is assessing the impact of these new standards.

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For the three and nine months ended September 30, 2010

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Accounting changes

In June 2009, the AcSB issued an amendment to CICA Handbook Section 1506: Accounting Changes which is effective for fiscal years beginning on or after July 1, 2009. The amendment excludes from the scope of CICA Handbook Section 1506 changes in accounting policies upon the complete replacement of an entity's primary basis of accounting, as will occur when an entity adopts IFRS.

5 Acquisition

On March 4, 2010, the Company announced that it, and a private partner, had acquired 100% of the shares of a private Texas based oil company, Production Resources Inc ("PRI"). Pursuant to the agreement, the Company and the private partner divided the interest, each obtaining 50%. As consideration for the purchase, the Company issued 5,000,000 common shares (\$0.08 CDN per share) and an 18 month consulting agreement valued at \$36,800 USD, for total consideration of \$425,000 USD.

On March 15, 2010, the Company sold 50% of its interest in the shares of PRI to a private Alberta company (the "PrivateCo") for consideration of \$214,750. As a result, the Company's ownership interest in PRI decreased to 25%. The Company has accounted for the investment using the equity method.

The investment in PRI as at September 30, 2010 is as follows:

	CDN\$
Purchase of 50% interest in PRI	437,919
Disposition of 50% interest in PRI to PrivateCo	(214,750)
Share of income for the period	8,879
Net investment	<u>232,048</u>

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

6 Property and equipment

	September 30, 2010		
	Cost	Accumulated depletion & depreciation	Net book value
	\$	\$	\$
Oil and gas properties	9,974,046	5,045,456	4,928,590
Other	297,927	162,922	135,005
	<u>10,271,973</u>	<u>5,208,378</u>	<u>5,063,595</u>

	December 31, 2009		
	Cost	Accumulated depletion & depreciation	Net book value
	\$	\$	\$
Oil and gas properties	9,591,657	4,651,768	4,939,889
Other	247,564	133,620	113,944
	<u>9,839,221</u>	<u>4,785,388</u>	<u>5,053,833</u>

The Company applied the ceiling test to its petroleum and natural gas properties at September 30, 2010 and determined that there was no impairment of costs which would require a write down.

7 Asset Retirement Obligation

The Company is legally required to restore its properties to their original condition. Estimated future site restoration costs are based upon engineering estimates of the anticipated method and the extent of site restoration required in accordance with current legislation and industry practices in the various jurisdictions in which the Company has properties.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

As at September 30, 2010, the Company estimated the total undiscounted amount of cash flows required to settle its ARO to be \$312,558 (December 31, 2009 - \$312,558), which are estimated to be incurred over the next 15 years. The Company calculated ARO using a credit adjusted risk free interest rate of 7.5% and an inflation rate of 2%, which resulted in the recording of ARO of \$139,704 (December 31, 2009 - \$131,757).

	September 30, 2010
	\$
Balance, beginning of period	131,757
Accretion	7,947
Balance, end of period	139,704

8 Bank Loan

The Company has a \$3,000,000 (December 31, 2009 - \$3,250,000) revolving operating demand loan (the "Revolving Loan"), of which \$2,525,000 (December 31, 2009 - \$2,935,019), has been drawn at September 30, 2010. Interest on the revolving loan is calculated at the bank's prime rate plus 2.0% (December 31, 2009 - bank's prime rate plus 1.50%).

During the nine months ended September 30, 2010, the Company obtained a non-revolving demand loan (the "Non-revolving Loan") of \$400,000 through the same bank holding the revolving loan. Interest on the non-revolving loan is calculated at the bank's prime rate plus 2.50%.

Security for the loans 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 required to maintain certain covenants, which the Company is in violation of as at September 30, 2010 (note 12). The bank has not made demand of the Company's credit facilities but retains the right to do so.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

9 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 \$
Outstanding, December 31, 2009	45,159,446	5,830,596
Shares issued on purchase of non-controlled subsidiary(i)	5,000,000	400,000
Tax effect of flow-through shares(ii)	-	(162,500)
Share issue costs	-	2,147
Private placement (iii)	8,350,000	411,968
Share issue costs (iii)	-	(47,340)
Outstanding, September 30, 2010	58,509,446	6,434,871

(i) On March 4, 2010, the Company issued 5,000,000 common shares with a value of \$400,000 (\$.08/share). These shares were issued as consideration for the purchase of 50% of the share of a private Texas based oil and gas company, PRI.

(ii) The Company committed to incur \$615,000 on qualifying exploration and development expenditures prior to December 31, 2010 relating to flow-through shares issued in 2009. The Company has renounced these expenditures as at December 31, 2009 and filed the necessary documents with the Canada Revenue Agency in 2010. Accordingly, the future income tax of \$162,500 has been recorded in the period. The Company has \$468,334 of expenditures remaining that must be incurred before December 31, 2010.

(iii) On September 30, 2010, the Company completed the first of two tranches of a private placement (the "Placement"), issuing 8,350,000 units for total proceeds of \$417,500, (\$0.05 per unit). Each unit consists of one common share of the Company (issued either as a common share or as a flow-through share (the "FTS")) and one common share purchase warrant (the "Warrant"). Each whole Warrant entitles the holder to purchase one additional common share of the Company at \$0.12 per share, exercisable for 1 year from the date of the Placement. Of the total 8,350,000

Emerald Bay Energy Inc.

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For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

units issued, 6,500,000 were issued as a FTS. The Company has allocated \$5,532 of the unit value to warrants (note 9(c)).

The Company incurred \$42,922 in cash share issue costs and issued 650,000 finders options (the "Finders Options") valued at \$4,418 (note 9(f)).

c) Warrants

Warrants to acquire common shares outstanding at September 30, 2010 are as follows:

	Number of warrants issued and exercisable	Amount \$	Weighted average exercise price \$	Weighted average Remaining life (years)
Balance, December 31, 2009	9,625,000	102,082	0.15	0.14
Share purchase warrants (9b(iii))	8,350,000	5,532	0.12	1.00
Expiry of warrants	(1,500,000)	-	-	-
Balance, September 30, 2010	16,475,000	107,614	0.135	0.59

The fair value of the share purchase warrants granted during the period 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:

Risk-free rate	1.40%
Expected life	1 year
Expected volatility	61.93%
Fair value per warrant	\$0.001

d) Stock options outstanding

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

For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

During the three and nine month period ended September 30, 2010, the Company granted nil and 3,450,000 stock options, 550,000 options expired unexercised, 613,117 Agent Options expired unexercised, and there were no exercises or cancellations. The following table summarizes information about the Company's stock options outstanding at September 30, 2010:

	September 30, 2010		December 31, 2009	
	Number of options	Weighted Average Exercise price \$	Number of options	Weighted Average Exercise price \$
Employee, Directors, Consultants				
Stock options, beginning of period	1,850,000	0.24	2,275,000	0.26
Granted	3,450,000	0.10	-	-
Expired	(550,000)	0.25	(425,000)	0.32
Stock options outstanding, end of period	4,750,000	0.13	1,850,000	0.24

	September 30, 2010		December 31, 2009	
	Number of options	Weighted Average Exercise price \$	Number of options	Weighted Average Exercise price \$
Agent Options				
Agent Options, beginning of period	1,090,617	0.12	613,117	0.15
Granted	-	-	477,500	0.08
Expired	(613,117)	0.15	-	-
Agent Options outstanding, end of period	477,500	0.08	1,090,617	0.12

The total stock options and Agent Options outstanding at September 30, 2010 are as follows:

Exercise prices	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price (\$)
\$0.08	477,500	0.12	0.08
\$0.10	3,450,000	4.52	0.10
\$0.17	200,000	2.07	0.17
\$0.25	1,100,000	0.29	0.25
	5,227,500	2.97	0.13

As at September 30, 2010 all outstanding options have vested and are exercisable.

e) Stock based compensation

During the three and nine months ended September 30, 2010, the Company granted nil and 3,450,000 options to officers, directors and consultants. The terms of the grant are consistent with the Plan and the options are exercisable at \$0.10 per option, 300,000 of which expire 2 years after the grant date, and 3,150,000 expire 5 years after the grant date. The fair value of

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

the options granted is estimated as at the grant date using the Black-Scholes option pricing model. The weighted average assumptions used in the calculation are noted below:

Risk-free interest rate	2.62%
Expected life	4.7 years
Expected volatility	66.27%
Fair value per option	0.032

Compensation expense recognized for the three and nine month period ended September 30, 2010 was \$nil and \$109,560 (September 30, 2009 - \$nil), all of which has been recorded as an offsetting credit to contributed surplus.

f) **Finders Options**

On September 30, 2010, the Company issued 650,000 Finders Options to the Finders who facilitated the September 30, 2010 Placement. Each Finders Option 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 \$0.12 per common share. The Finders Options expire on September 30, 2011.

The Finders Options were valued at \$4,418. 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:

Risk-free interest rate	1.40%
Expected life	1 years
Expected volatility	61.93%
Fair value per option	0.01

g) **Diluted (loss) earnings per share**

Basic earnings per share are calculated based on the weighted average number of shares outstanding during the three and nine months ended September 30, 2010 of 50,159,446 and 49,019,740, respectively. 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, Finder Options 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, 2010

(Unaudited - expressed in Canadian dollars)

10 Related Parties

a) The following amounts are due by related parties:

	September 30, 2010	December 31, 2009
	\$	\$
Note receivable from officer (i)	223,402	218,500
Fair value allowance (ii)	(206,710)	(206,710)
Net note receivable	16,692	11,790
Advance fees (iii)	38,529	51,448
	55,221	63,238

- (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 \$15,720 at September 30, 2010 (December 31, 2009 - \$35,370).
- (ii) The fair value allowance was determined in 2008, based on the market value at December 31, 2008 of the secured shares. The Company has not provided an allowance to the estimated fair value of the 393,000 common shares held as security as the fair value at September 30, 2010 and December 31, 2009 exceeded the carrying amount.
- (iii) A director was advanced fees in relation to efforts to finance and advance the Company's drilling technology. At September 30, 2010 \$38,529 (December 31, 2009 - \$51,448) 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 by December 31, 2010.

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For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

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

For the three month period ended September 30, 2010:

- (i) Aggregate fees of \$70,250 (September 30, 2009 - \$44,330) were charged by directors and officers of the Company. Of this amount \$51,350 (September 30, 2009 - \$44,330) was recorded in the statement of loss, comprehensive loss and deficit and \$18,900 was capitalized to property, plant and equipment.
- (ii) Aggregate legal fees of \$nil (September 30, 2009 - \$643) were charged by a law firm in which a director of the Company is a partner, and were expensed as general and administrative expenses.
- (iii) Aggregate fees of \$10,800 (September 30, 2009 - \$13,860) 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. These fees were recorded in the statement of loss, comprehensive loss and deficit.

For the nine month period ended September 30, 2010:

- (iv) Aggregate fees of \$193,657 (September 30, 2009 - \$217,425) were charged by officers of the Company. Of this amount \$144,307 (September 30, 2009 - \$144,307) was recorded in the statement of loss, comprehensive loss and deficit and \$49,350 was capitalized to property, plant and equipment.
- (v) Aggregate legal fees of \$7,854 (September 30, 2009 - \$8,742) were charged by a law firm in which a director of the Company is a partner of, and were expensed as general and administrative expenses.
- (vi) Aggregate fees of \$32,400 (September 30, 2009 - \$41,580) 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. These fees were recorded in the statement of loss, comprehensive loss and deficit.
- (vii) Included in accounts payable at September 30, 2010 was \$36,200 owing to related parties of the Company.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

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.

11 Financial Instruments and Risk Management

a) Fair values

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, the financial contract, the equity investment and accounts payable and accrued liabilities. The fair values of these financial instruments approximate their carrying value due to their short-term nature.

Effective December 31, 2009, the Company adopted the amendments to CICA Section 3862 "Financial Instruments – Disclosures". These amendments require the Company to present information about financial instruments measured at fair value in accordance with a three level hierarchy. The hierarchy groups financial assets and liabilities into three levels based on the significance of inputs used in measuring the fair values of the financial assets and liabilities. The fair value hierarchy has the following levels:

- (i) Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities;
- (ii) Level 2: inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly (i.e. as prices) or indirectly (i.e. derived from prices);
and
- (iii) Level 3: inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The level within which the financial asset or liability is classified is determined based on the lowest level of significant input to the fair value measurement. At September 30, 2010, the Company's cash and cash equivalents, the financial contract, and the equity investment have been assessed based on the fair value hierarchy above. Cash and cash equivalents are assessed through level 1, the financial contract through level 2, and the equity investment through level 3. Assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the placement within the fair value hierarchy.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

b) **Credit risk**

The majority of the Company's accounts receivable are due from joint venture partners in the oil and gas industry and from purchasers of the Company's petroleum and natural gas production and are subject to the same industry factors such as commodity price fluctuations and escalating costs. The Company 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 Company has not experienced any credit loss in the collection of accounts receivable in the period ended September 30, 2010.

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 Company's oil and natural gas production are from major marketing companies. The Company 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 Company 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 before they commence.

c) **Market risk**

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

Commodity price risk

The Company is exposed to commodity price risk on oil and gas revenues. As a means to mitigate the exposure to commodity price volatility, during September 2009 the Company entered into a derivative financial instrument effective January 1, 2010 to December 31, 2010, which collared the received price of natural gas between \$4.53/GJ and \$7.53/GJ for 500 GJ/day.

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The Company's derivative financial instruments are classified as held-for-trading and are reported at fair value with changes in fair value recorded through the statement of loss, comprehensive loss, and deficit. The following table summarizes the fair value as at September 30, 2010:

Financial contract, March 31, 2010	102,060
Unrealized loss	(53,341)
Financial contract, September 30, 2010	<u>48,719</u>

At present, the Company produces primarily natural gas. A \$.50 mcf increase or decrease in the price received for natural gas would result in approximately a \$25,400 and \$81,500, respectively, increase or decrease in the Petroleum and Natural Gas sales for the three and nine months ended September 30, 2010.

Interest rate risk

The Company is exposed to interest rate risk on its revolving loan and non-revolving loan, which have interest rates of prime plus 2.00% and prime plus 2.5%, respectively. An estimated 1% increase or decrease in the interest rate would have affected the Company's statement of operations by \$20,500 for the nine months ended September 30, 2010.

d) **Currency risk**

The Company is exposed to the financial risk related to the fluctuation of foreign exchange rates. The Company operates in Canada and the United States and a portion of its expenses are incurred in US dollars. The Company does not hedge its exposure to fluctuations in the exchange rate. Future changes in exchange rates could have a material effect on the Company's business including its intended capital plans, its financial condition and results of operations.

Certain of the Company's financial instruments are exposed to fluctuations in the US dollar, including cash and cash equivalents, accounts receivable and accounts payable and accrued liabilities. As at September 30, 2010, an increase or decrease of 10% to the foreign exchange rate between the US dollar and the Canadian dollar applied to the average level of US denominated cash and cash equivalents would have had approximately a \$5,900 impact on the Company's earnings for the quarter.

Emerald Bay Energy Inc.

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For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

e) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due. This may be the consequence of diminished cash flows resulting from lower product prices, production interruptions, or unexpected operating or capital cost increases. Liquidity difficulties could also occur if the Company's bankers were unable to continue to provide credit (when and if applicable) at a level and on terms compatible with the Company's capital requirements. The Company ensures, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, without incurring unacceptable losses or harm to the Company's reputation.

Generally, the Company will, over a reasonable period of time, limit its capital programs to funds flow from operations, available cash and available credit. In addition, the Company endeavors to maintain its debt at a level that will ensure financial flexibility to deal with unforeseen or rapidly changing circumstances.

The Company's net current liabilities and other liabilities and the manner in which they are expected to be met are as follows:

Net working capital deficiency	\$1,696,032	This amount is anticipated to be met out of additional share issuance in the 2010 fiscal period.
Bank debt (Note 8)	\$2,925,000	The Company anticipates issuing additional share capital to reduce this amount in 2010. This amount is secured by the Company's oil and gas assets which have value sufficient such that the Company has no reason to believe that the bank will require repayment within the next fiscal period.
Long term debt	\$95,624	Vehicle loans will be paid over 5 years out of normal cash flow.

12 Capital management

The Company's capital consists of shareholders' equity, bank debt and working capital. The Company 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.

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Notes to the Financial Statements

For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

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

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

The Company 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, 2010, the Company was in violation of this bank covenant with a ratio of 0.61:1. The bank has not made demand of the Company's credit facilities but retains the right to do so.

In order to resolve its working capital ratio and to access additional share equity the Company will be emphasizing development of its U.S. properties. The Company has received preliminary expressions of interest from third parties, interested in investing substantial sums in the Company if it focuses on its US properties.

13 Commitments

- a) Under a lease agreement for five (5) years commencing April 1, 2009 and ending March 31, 2014, the Company has committed to payments of \$5,420 per month under a rental agreement for 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 principle repayments for fiscal years 2010 through to 2015 are respectively as follows: \$18,050, \$22,075, \$23,345, \$24,688, \$26,110 and \$15,825.
- c) As partial consideration for the non-controlling acquisition of the shares of a Texas oil and gas company, the Company has entered into a consulting contract aggregating \$37,919 (USD -\$36,800). The contract commences March 1, 2010 and has a term of 18 months.
- d) The Company is committed to renounce to subscribers \$468,334 of expenditures that qualify as Canadian Exploration Expenses ("CEE") for Canadian income tax purposes and to incur these expenditures no later than December 31, 2010.

Emerald Bay Energy Inc.

Notes to the Financial Statements

For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

- e) The Company is committed to renounce to subscribers \$325,000 of expenditures that qualify as CEE for Canadian income tax purposes and to incur these expenditures no later than December 31, 2011.

14 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 ended September 30, 2010 (\$)		
	Canada	United States	Total
Petroleum and natural gas sales	314,019	797	314,816
Interest income	5,008	3,508	8,516
Depletion, depreciation and accretion	131,832	12,560	144,392
Net loss	359,600	14,932	374,532

	Nine months ended September 30, 2010 (\$)		
	Canada	United States	Total
Petroleum and natural gas sales	1,021,319	66,543	1,087,862
Interest income	10,000	-	10,000
Depletion, depreciation and accretion	399,641	41,074	440,715
Net loss	687,640	135,965	823,605
Property and equipment	4,745,563	318,032	5,063,595
License	2,959	-	2,959

15 Subsequent Events

The Company entered into the following transaction subsequent to September 30, 2010:

- a) On October 27, 2010, the Company closed the final tranche of the Placement (note 9(b)(iii)), issuing 500,000 units for total proceeds of \$25,000, (\$0.05 per unit). Each unit consists of one common share of the Company (issued either as a common share or as a FTS) and one Warrant. Each whole Warrant entitles the holder to purchase one additional common share of the Company at \$0.12 per share, exercisable for 1 year from the date of the Placement. Of the total 500,000 units issued, 400,000 were issued as a FTS.

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For the three and nine months ended September 30, 2010

(Unaudited - expressed in Canadian dollars)

- b) On October 27, 2010, the Company entered into a derivative financial instrument, which becomes effective on January 1, 2011 to December 31, 2011. This instrument fixes the received price of natural gas at CDN 4.684 per GJ.

- c) On October 28, 2010, the Company entered into two commodity call options (the "Options"). The first option is effective from January 1, 2011 to December 31, 2011 and the second option is effective from January 1, 2012 to December 31, 2012. Both Options have a strike price of USD \$90.00 per BBL.