



Emerald Bay Energy

**Emerald Bay Energy Inc.
Audited Financial Statements
For the years ended December 31, 2009 and 2008**

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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, 2009 and 2008 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, 2009 and 2008 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 30, 2010

**Emerald Bay Energy Inc.
Balance Sheets**

As at December 31	2009	2008
Assets		
Current		
Cash	\$ 142,728	\$ 259,159
Short term investments	55,864	61,131
Accounts and cash call receivable	970,257	1,336,826
Prepaid expenses	64,212	53,238
	1,233,061	1,710,354
Due from related parties (Note 8)	63,238	71,263
Property and equipment (Note 4)	5,053,833	4,642,003
Accounts and cash call receivable	-	61,000
License (Note 5)	11,835	21,589
	\$ 6,361,967	\$ 6,506,209
 Liabilities and Shareholders' Equity		
Current		
Bank loan (Note 7)	\$ 2,935,019	\$ 2,275,000
Accounts payable and accrued liabilities	2,616,909	2,128,281
Current portion of long term debt(Note 15)	13,079	-
	5,565,007	4,403,281
Long term debt (Note 15)	67,919	-
Asset retirement obligations (Note 6)	131,757	104,942
	5,764,683	4,508,223
Going concern assumption (Note 2)		
Contingencies (Note 14)		
Commitments (Note 15)		
Subsequent events (Note 17)		
Shareholders' equity		
Equity instruments (Note 9(b))	5,932,679	5,703,729
Contributed surplus (Note 10)	766,924	762,149
Deficit	(6,102,319)	(4,467,892)
	597,284	1,997,986
	\$ 6,361,967	\$ 6,506,209

“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	2009	2008
Revenue		
Petroleum and natural gas sales	\$ 1,487,795	\$ 2,890,701
Royalties	<u>(216,462)</u>	<u>(603,125)</u>
	<u>1,271,333</u>	<u>2,287,576</u>
Expenses		
Operating	945,678	726,409
General and administrative (Note 8 (b))	1,242,824	1,219,262
Depletion, amortization and accretion	905,864	857,022
Interest	112,390	142,055
Fair value allowance (Note 8 a) (ii)	-	35,370
Bad debt expense	-	38,793
Foreign exchange loss	46,068	-
Interest income	<u>(11,064)</u>	<u>(9,060)</u>
	<u>3,241,760</u>	<u>3,009,851</u>
Loss from operations	<u>(1,970,427)</u>	<u>(722,275)</u>
Future income tax recovery (Note 11)	<u>336,000</u>	<u>-</u>
Net loss and comprehensive loss for the year	(1,634,427)	(722,275)
Deficit, beginning of year	(4,467,892)	(3,745,617)
Deficit, end of year	<u>\$ (6,102,319)</u>	<u>\$ (4,467,892)</u>
Loss per common share (Note 9(d))		
Basic and diluted	\$ (0.05)	\$ (0.02)
Weighted average number of common shares outstanding basic and diluted		
	37,758,761	30,012,753

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

2009

2008

Cash provided by (used in)

Operating activities

Loss for the year	\$	\$
	(1,634,427)	(722,275)
Items not affecting cash:		
Depletion, amortization and accretion	896,110	846,728
Amortization of license fee	9,754	10,294
Fair value allowance	-	35,370
Future income tax	(336,000)	-
Asset retirement payments	(18,450)	-
	(1,083,013)	170,117

Changes in non-cash operating balances

Accounts, cash calls and related party receivables	435,594	
Prepaid expenses and deposits	(5,707)	(473,530)
Accounts payable and accrued liabilities		(8,737)
	488,628	(178,401)
	(164,498)	(490,551)

Financing activities

Bank loan	660,019	950,000
Long term borrowing	85,869	-
Repayment of long term debt	(4,871)	-
Issuance of share capital and warrants, net of costs	569,725	1,000,589
	1,310,742	1,950,589

Investing activities

Purchases of property and equipment		(1,215,875)
	(1,262,675)	(1,215,875)

Increase (Decrease) in cash

	(116,431)	244,163
Cash, beginning of year	259,159	14,996

Cash, end of year

	\$ 142,728	\$ 259,159
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Supplemental cash flow information

2009

2008

Interest paid	\$ 112,390	\$ 142,055
Interest received	\$ 11,064	\$ 9,060

The Company conducted non-cash financing activities as follows:

Fair value of agent options	\$ 4,775	-
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The accompanying notes are an integral part of these financial statements.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2009 and 2008

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 \$4,331,946 working capital deficiency at December 31, 2009.

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.

The Company is required to maintain certain banking covenants that it is in violation of at year end. The bank has not made demand of the Corporation's credit facilities but retains the right to do so.

The Corporation committed to incur \$650,000 on qualifying exploration and development expenditures prior to December 31, 2010 relating to flow-through share agreements issued in 2009. This amount remains to be incurred at December 31, 2009.

The Company has experienced recurring net losses and negative cash flow. In order to address this, the Company is focusing its development on the United States oil acreage. This prospect produces better returns due to higher oil prices compared with natural gas, has greater drilling potential and more locations. In addition, preliminary discussions indicate that certain potential investors are more willing to invest significant sums for this project than for the Company's Canadian projects.

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.

Emerald Bay Energy Inc. Notes To Financial Statements

December 31, 2009 and 2008

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.

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.

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 on a country by country basis. Such costs include land acquisition costs, geological and geophysical expenses, carrying charges on non-producing properties, costs of drilling and overhead charges directly related to acquisition and exploration activities.

Costs capitalized, together with the costs of production equipment, are depleted on the unit-of-production method based on the estimated gross proved reserves. Petroleum products and reserves are converted to equivalent units of natural gas at approximately 6,000 cubic feet to 1 barrel of oil.

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion calculations. Proceeds from the sale of petroleum and natural gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would 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.

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.

Emerald Bay Energy Inc. Notes To Financial Statements

December 31, 2009 and 2008

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.

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.

Financial instruments

Financial assets and financial liabilities, including derivatives, are required to 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 and short term investments are designated as “held-for-trading”. Accounts receivable and due from related parties are designated as “loans or receivables”. The revolving operating loan and accounts payable and accrued liabilities are designated as “other liabilities”.

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

Comprehensive Income 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 years ended December 31, 2009 and 2008.

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.

Emerald Bay Energy Inc. Notes To Financial Statements

December 31, 2009 and 2008

Hedges

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.

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.

Foreign currency translations

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.

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.

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.

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.

Share issue costs

Share issue costs incurred on the issue of the Company's shares are charged directly to share capital, and are net of applicable future income tax benefits.

Emerald Bay Energy Inc. Notes To Financial Statements

December 31, 2009 and 2008

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.

Financial Instruments – disclosures and Presentation

The Corporation provides disclosure which 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.

Capital Disclosures

The Corporation discloses its 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.

Valuation of equity units issued in private placements

The Company uses the fair value method to value any warrants and agent options issued in private placements. The fair value assigned to warrants is recorded as a reduction to share capital and an increase to warrants. The fair value assigned to agent options is recorded as share issue costs and an increase to contributed surplus.

New and Future accounting changes

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:

Effective January 1, 2009, The Corporation adopted Section 3064, *Goodwill and Intangible Assets* and amended Section 1000, *Financial Statement Concepts*. Items that no longer meet the definition of an asset are no longer recognized with assets. The Corporation does not expect the adoption of this section to have a material impact on our results of operations or financial position.

During 2009, The Corporation adopted CICA issued amendments to Handbook Section 3862, *Financial Instruments – Disclosures*. The amendments include enhanced disclosures relating to the fair value of financial instruments and the liquidity risk associated with financial statements. Section 3862 now requires that all financial instruments measured at fair value be categorized into one of three hierarchy levels. Refer to Note 12 Financial Instruments and Financial Risk Management for enhanced fair value disclosures. The amendments are consistent with recent amendments to financial instrument disclosure standards in IFRS.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2009 and 2008

In January 2009, the AcSB issued Section 1582, *Business Combinations*, which replaces former guidance on business combinations. Section 1582 establishes principles and requirements of the acquisition method for business combinations and related disclosures. This statement 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 2011 with earlier application permitted.

In January 2009, the AcSB issued Sections 1601, *Consolidated Financial Statements*, and 1602, *Non-controlling Interests*, which replaces existing guidance. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 provides guidance on accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. These standards are effective on or after the beginning of the first annual reporting period beginning on or after January 2011 with earlier application permitted.

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. The Company has completed a conversion of its accounting system to one which can provide the necessary IFRS inputs. This project was completed over the 3rd and 4th quarters of 2009 and the first quarter of 2010. An assessment of necessary modifications to the converted system is the next step and will be completed during the second and third quarters of 2010.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2009 and 2008

4. Property and Equipment

	December 31, 2009			December 31, 2008		
	Cost	Accumulated Depletion and Amortization	Net Book Value	Cost	Accumulated Depletion and Amortization	Net Book Value
Petroleum and natural gas properties	\$ 9,591,637	\$ 4,651,768	\$ 4,939,869	\$ 8,395,054	\$ 3,806,522	\$4,588,532
Furniture and Equipment	247,584	133,620	113,964	146,821	93,350	53,471
	\$ 9,839,221	\$ 4,785,388	\$ 5,053,833	\$ 8,541,875	\$ 3,899,872	\$4,642,003

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, 2009 and determined that there was an impairment of costs to its US properties requiring a write down of \$289,171. Future development costs of \$1,091,000 (2008 - \$1,380,000) were added to the depletion calculation. Unproved properties of \$117,000 (2008 - \$nil) were excluded from the calculation. Estimated salvage value on tangible assets of \$562,000 (2008 - \$nil) have been excluded from the calculation.

The following table outlines benchmark prices adjusted for differential specific to the Corporation's production was used in the impairment test at December 31, 2009:

Year	WTI (\$U.S./bbl)	AECO – C (\$Cdn/Mmbtu)
2010	80.00	5.96
2011	83.00	6.79
2012	86.00	6.89
2013	89.00	6.95
2014	92.00	7.05
	2% escalation thereafter	

5. License

	2009	2008
License fee	71,000	71,000
Accumulated amortization	(59,165)	(49,411)
	11,835	21,589

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2009 and 2008

6. 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 \$147,442 as at December 31, 2009 based on a total future liability of \$312,558, and incorporated the Company's credit-adjusted risk-free interest rate of 7.5%. These payments are expected to be made over the next 15 years.

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

	<u>2009</u>	<u>2008</u>
Asset retirement obligation, beginning of year	\$ 104,942	\$ 139,043
Liabilities discharged	(18,450)	-
Liabilities incurred	39,971	53,715
Revisions to previously recorded liabilities	(5,300)	(98,244)
Accretion expense	10,594	10,428
Asset retirement obligation, end of year	<u>\$ 131,757</u>	<u>\$ 104,942</u>

7. Bank Loan

The Company has a \$3,250,000 (2008 - \$3,250,000) revolving operating demand loan, of which \$2,935,019 (2008 - 2,275,000), has been drawn at December 31, 2009. Interest is calculated at the bank's prime rate plus 1.50%.

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 working capital covenants that it is in violation of at year end. The bank has not made demand of the Corporation's credit facilities but retains the right to do so.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2009 and 2008

8. Due from Related Parties and Related Party Transactions

a) The following amounts are due by related parties:

	Dec 31, 2009	Dec 31, 2008
Due from related party		
Note receivable from officer (i)	\$ 218,500	\$ 218,500
Fair value allowance (ii)	(206,710)	(206,710)
	11,790	11,790
Advance fees (iii)	51,448	59,473
	\$ 63,238	\$ 71,263

(i) Note receivable from officer - Promissory note 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 \$35,370 at December 31, 2009.

(ii) The fair value allowance was determined in 2008, based on the market value at December 31, 2008 of the secured shares. The Corporation has not provided an allowance in 2009 to the estimated fair value of the 393,000 common shares held as security as the fair value at December 31, 2009 of \$35,370 exceeded the carrying amount.

(iii) A director was advanced fees totaling \$nil (2008 - \$59,473) in relation to efforts to finance and advance the Company's drilling technology. At December 31, 2009 \$51,448 (2008 - \$59,473) remains outstanding. There is no guarantee that such effort will be successful and if such efforts are not successful, the full balance will be repaid by December 31, 2010.

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, 2009.

(i) Directors and officers, have charged the Company \$276,569 (2008 - \$278,300) for management services related to managing the day to day operations of the Company in Canada and the United States, inclusive of filling the role of Company President.

(ii) A law firm in which a director is a partner has charged the Company \$33,200 (2008 - \$59,685) in legal fees for normal corporate matters.

(iii) An oil and gas completions, operations, geological and consulting firm owned 100% by a director has charged the Company \$187,319 (2008 - \$166,950) in consulting fees.

(iv) A U.S. corporation, owned and controlled by an officer and a director has charged the Company \$77,000 (2008 - \$159,500) for costs it incurred for operation of the Company's U.S. properties.

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

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2009 and 2008

9. Equity Instruments

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

- b) Issued

	December 31, 2009	
	Number of Shares	Amount
Common shares issued and issuable for cash		
Balance, beginning of year	37,034,446	5,681,646
Tax effect of flow-through shares		(336,000)
Private placement of flow-through units (i)(ii)	8,125,000	650,000
Value assigned to warrants		(80,000)
Share issue costs		(66,050)
Share subscription receivable		(19,000)
Balance, end of year	45,159,446	5,830,596
Warrants outstanding beginning of year	1,500,000	22,083
Private placement of flow-through units (iii)	8,125,000	80,000
Balance, end of year	9,625,000	102,083
Equity instruments balance December 31, 2009		\$ 5,932,679

	December 31, 2008	
	Number of Shares	Amount
Common shares issued and issuable for cash		
Balance, beginning of year	27,903,277	\$ 4,729,136
Private placement September 2008	6,131,169	919,375
Private placement December 2008	3,000,000	300,000
Value assigned to warrants	-	(22,083)
Share issue costs	-	(245,082)
Balance, end of year	37,034,446	5,681,646
Warrants outstanding beginning of year	-	-
Warrants	1,500,000	22,083
Balance, end of year	1,500,000	22,083
Equity instruments balance December 31, 2008		\$ 5,703,729

- (i) On November 20, 2009 the Company completed a private placement through the issuance of 6,250,000 units (the "Unit") for total proceeds of \$500,000 (\$0.08/share). Of the total units issued under the private placement, 5,812,500 were issued as flow through shares. Each unit consists of one common share or one flow through share and one non-transferable share purchase warrant (the "Warrant"). Each full warrant entitles the holder to purchase one additional common share of the Company for a period of 12 months from the date of issue of the unit at a price of \$0.15. Share issue costs of \$35,000 were charged against the value of the private placement.
- (ii) On December 31, 2009 the Company completed the first tranche of a larger private placement. Pursuant to the private placement, 1,875,000 units were issued for gross proceeds of \$150,000 (\$0.08/share). Each units consists of one flow through share and one share purchase warrant. Share issue costs of \$31,050 were charged against the value of the private placement.
- (iii) The fair value of the warrants was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (Nil), expected volatility (55%), risk-free

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interest rate of (1.5%), and weighted average life of 1 year. A total estimated value of \$80,000 was assigned as the fair value of the warrants issued pursuant to each private placement. The estimated value of \$4,775 (2008-\$25,996) was for the agent options granted in the year, that have been charged to share issue costs with a corresponding credit to contributed surplus.

As at December 31, 2009, the Company has met its commitment to spend the total flow through funds raised in 2008 of \$1,219,375 and renounced in full to the shareholders by year end.

The Corporation committed to incur \$650,000 on qualifying exploration and development expenditures prior to December 31, 2010 relating to flow-through share agreements issued in 2009. This amount remains to be incurred at December 31, 2009.

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 2009 and 2008 vest immediately on issuance.

	December 31, 2009		December 31, 2008	
	Number of options	Weighted Average Exercise price	Number of options	Weighted Average Exercise price
<u>Employee, Directors, Consultants</u>				
Stock options, beginning of year	2,275,000	\$0.26	2,525,000	\$ 0.26
Granted	-	-	-	0.17
Expired	(425,000)	0.32	(250,000)	0.19
Stock options outstanding, end of year	1,850,000	0.24	2,275,000	\$ 0.26
Exercisable, end of year	1,850,000	\$0.24	2,275,000	\$ 0.26

	December 31, 2009		December 31, 2008	
	Number of options	Weighted Average Exercise price (\$)	Number of options	Weighted Average Exercise price
<u>Agents</u>				
Agent options, beginning of year	613,117	\$0.15	-	\$ -
Agent options granted	477,500	0.08	613,117	-
Agent options outstanding, end of year	1,090,617	0.12	613,117	\$ 0.15
Exercisable, end of year	1,090,617	0.12	613,117	\$ 0.15

In 2009, the Company granted 477,500 agent stock options (2008 – 613,117), at a price of \$0.08 per share vesting immediately with a 12 month term. These were granted in connection with the respective private placements conducted in fiscal 2009 and fiscal 2008.

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 (1.5%), and weighted average life of 1 year.

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The total stock options outstanding as at December 31, 2009 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>
\$0.08	477,500	0.9	\$0.08	477,500	\$0.08
\$0.15	613,117	0.3	0.15	613,117	0.15
\$0.17	200,000	2.8	0.17	200,000	0.17
\$0.25	1,650,000	0.9	0.25	1,650,000	0.25
	<u>2,940,617</u>	<u>0.9</u>	<u>\$0.20</u>	<u>2,940,617</u>	<u>\$0.20</u>

The total stock options outstanding as at December 31, 2008 were 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>
\$0.15	613,117	1.3	0.15	613,117	0.15
\$0.17	200,000	3.8	\$ 0.17	200,000	\$ 0.17
\$0.25	1,650,000	1.9	0.25	1,650,000	0.25
\$0.32	425,000	1.0	0.32	425,000	0.32
	<u>2,888,117</u>	<u>2.0</u>	<u>\$ 0.22</u>	<u>2,888,117</u>	<u>\$ 0.22</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

The following table reconciles the Company's contributed surplus for the years ended December 31, 2009 and 2008.

	2009	2008
Balance outstanding, beginning of year	\$ 762,149	\$ 736,153
Agents options issued	4,775	25,996
Balance outstanding, end of year	\$ 766,924	\$ 762,149

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11. Income taxes

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

	<u>2009</u>	<u>2008</u>
Combined tax rate	29.0%	29.5%
Expected income tax provision at statutory rate	\$ (571,000)	\$ (213,000)
Non-deductible expenses	(7,000)	7,800
Rate change	78,000	36,000
Valuation allowance	189,000	245,000
Other	(25,000)	(75,800)
Future income tax recovery	\$ (336,000)	\$ -

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

	<u>2009</u>	<u>2008</u>
Intangible tax assets	\$ 2,831,000	\$ 3,946,000
Undepreciated Capital Cost (UCC)	1,112,250	456,200
Share issue costs	136,400	276,000
Scientific Research and Experimental Development (SR&ED)	602,700	602,700
Attributed Canadian Royalty Income (ACRI)	1,100,800	1,100,800
Non-capital losses	2,017,000	427,300

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	<u>2009</u>	<u>2008</u>
Property and equipment, ARO, License Fee	\$ (253,000)	\$ (59,000)
Share issue costs	55,000	69,000
Scientific Research and Experimental Development	151,000	151,000
Investment tax credits	195,000	195,000
Attributed Canadian royalty income	110,000	110,000
Loss carry-forward	504,000	107,000
Valuation allowance	(762,000)	(573,000)
Future income tax liability	\$ -	\$ -

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12. 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) Liquidity risk

Liquidity difficulties would emerge if the Corporation were unable to meet its financial obligations as they fell due within normal credit terms. 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 Corporation's bankers were unable to continue to provide credit (when and if applicable) at a level and on terms compatible with the Corporation's capital requirements. Generally, the Corporation will, over a reasonable period of time, limit its capital programs to funds flow from operations, available cash and available credit. In addition, the Corporation 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	\$1,396,927	This amount is anticipated to be met out of additional share issuance in the 2010 fiscal period.
Bank debt (Note 7)	\$2,935,019	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	\$67,919	This amount will be paid over five years out of normal cash flow.

b) 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. 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 \$14,000 increase or decrease in monthly Petroleum and Natural Gas sales. In the past the Company has sold all of its gas on the spot market which historically has outperformed many corporation's active hedging programs. However, in order to reduce risk in 2010, the Company has entered into a financial instrument collaring the received price of natural gas between \$4.53/GJ and \$7.53/GJ for 500 GJ/day. The Corporation is exposed to

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interest rate risk on its bank loan which has an interest rate of prime plus 1.50%. An estimated one percent change in the interest rate either way for the year would have affected the Corporation's statement of operations by \$26,000 for the year ended December 31, 2009 (2008 - \$18,000)

c) 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 2009.

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.

d) Fair value of financial instruments

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

All of the Corporation's cash and cash equivalents are transacted in active markets and has been classified as Level 1 per below. The Corporation classifies the fair value of these transactions according to the following hierarchy based upon the observable inputs used to value the instrument.

Level 1 – Quoted prices are available in active markets for identical assets as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an on-going basis.

Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices in Level 2 are either directly or indirectly observable as of the reporting date. Level 2 transactions are based on inputs, including quoted forward prices for commodities, time value and volatility factors which can be substantially observed or corroborated in the marketplace.

Level 3 – Valuations in this level are those with inputs for the asset or liability which are not based on observable market data.

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 level.

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e) 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 December 31, 2009, the Corporation was in violation of this bank covenant – See Note 7 and Note 2.

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. Segmented Information

The Company's oil and gas production is split between 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.

Dec 31, 2009	Canada	US	Total
Petroleum and natural gas sales	\$ 1,356,829	\$ 101,598	\$ 1,487,795
Oil & gas production assets	\$ 4,724,809	\$ 329,024	\$ 5,053,833
License	\$ 11,835		\$ 11,835

Dec 31, 2008	Canada	US	Total
Petroleum and natural gas sales	\$ 2,748,030	\$ 142,671	\$ 2,890,701
Oil & gas production assets	\$ 3,820,726	\$ 822,277	\$ 4,643,003
License	\$ 20,589		\$ 20,589

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14. Contingencies

In 2008, an oilfield service provider commenced legal action against the Company relating to disputed cost overruns during drilling operations totalling \$110,675. As a result of the incident the Company has counterclaimed for \$246,437 plus additional damages. In the opinion of management, the outcome of this action is not determinable at this time and as the Company has only an 18% interest in the action it will have no material outflow or recovery.

15. Commitments

Under a lease arrangement for five (5) years commencing April 1, 2009 and ending March 31, 2014 the Corporation was committed to payments of \$5,420 per month under a rental agreement for office space.

Long-term debt – Vehicle Leases

The Company has entered into various vehicle lease agreements with estimated minimum annual payments of \$17,359 per year through 2015. Total annual principle repayments for fiscal years 2010 through to 2015 are respectively as follows: \$13,079, \$13,553, \$13,776, \$14,554, \$15,082 and \$10,954.

16. Comparative Figures

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

17. Subsequent Events

On March 4, 2010, the Corporation announced that it and a private partner had acquired a 100% of the shares of a private Texas based oil company, Production Resources Inc. (PRI). The Corporation will issue five million of its common shares at \$0.08 CDN per share) along with an 18 month consulting agreement totaling \$36,800 US to the seller for a 50% interest in PRI for consideration of \$425,000 US. PRI's assets are 75 oil wells providing approximately 30 barrels of oil per day with development prospects.

On April 6, 2010, the Corporation announced that it has granted incentive stock options for a total of 3,150,000 common shares of the Corporation at a price of \$0.10 per share for a period of five years, under the formal stock option plan approved at the annual general meeting held on December 22, 2009 subject to regulatory approval, to directors, officers, employees and consultants of the Corporation.