



## *Emerald Bay Energy*

**Financial Statements  
December 31, 2010 and 2009  
(expressed in Canadian dollars)**

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**Independent Auditor's Report**

**To the Shareholders of  
Emerald Bay Energy, Inc.**

We have audited the accompanying financial statements of Emerald Bay Energy, Inc., which comprise the balance sheets as at December 31, 2010 and December 31, 2009, and the statements of operations, comprehensive loss and deficit and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

**Auditor's Responsibility**

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 comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the financial statements present fairly, in all material respects, the financial position of Emerald Bay Energy, Inc. as at December 31, 2010 and December 31, 2009, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

**Emphasis of matter**

Without modifying our opinion, we draw attention to Note 2 to the financial statements which describes the material uncertainty that may cast significant doubt about the ability of Emerald Bay Energy, Inc. to continue as a going concern.

**"MacKay LLP"**

**Chartered Accountants  
Calgary, Alberta  
May 2, 2011**

# **Emerald Bay Energy Inc.**

## Balance Sheets

**As at December 31, 2010 and December 31, 2009**

(Audited - expressed in Canadian dollars)

	December 31, 2010	December 31, 2009
	\$	\$
<b>Assets</b>		
<b>Current Assets</b>		
Cash	38,334	142,728
Short term investments	50,989	55,864
Accounts and cash call receivable	732,805	970,257
Prepaid expenditures	35,582	64,212
	<u>857,710</u>	<u>1,233,061</u>
Due from related parties (note 12(a))	51,373	63,238
Property, plant and equipment (note 7)	5,251,140	5,053,833
License	-	11,835
Investment in Production Resources Inc (note 6)	226,272	-
	<u>6,386,495</u>	<u>6,361,967</u>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Bank loan (note 9)	3,275,000	2,935,019
Accounts payable and accrued liabilities	2,596,818	2,616,909
Current portion of long term debt (note 15(b))	22,075	13,079
Financial contract (note 13(c))	3,278	-
	<u>5,897,171</u>	<u>5,565,007</u>
Long term debt (note 15(b))	89,989	67,919
Asset retirement obligation (note 8)	176,768	131,757
Financial contract (note 13(c))	150,488	-
	<u>6,314,416</u>	<u>5,764,683</u>
<b>Shareholders' equity</b>		
Share capital (note 10(b))	6,619,116	5,830,596
Warrants (note 10(c))	13,336	102,083
Contributed surplus (note 10(g))	984,233	766,924
Deficit	(7,544,606)	(6,102,319)
	<u>72,079</u>	<u>597,284</u>
	<u>6,386,495</u>	<u>6,361,967</u>

**Nature of operations (note 1)**

**Going Concern (note 2)**

**Commitments (note 15)**

**Subsequent events (note 18)**

Approved on Behalf of the Board:

"Shelby D. Beattie"  
Shelby D. Beattie, Director

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

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

# Emerald Bay Energy Inc.

## Statements of Operations, Comprehensive Loss and Deficit For the years ended December 31, 2010 and 2009

(Audited - expressed in Canadian dollars)

	2010 \$	2009 \$
<b>Revenue</b>		
Petroleum and natural gas sales	1,311,685	1,487,795
Royalties	(243,103)	(216,462)
	<b>1,068,582</b>	<b>1,271,333</b>
<b>Expenses</b>		
Operating	610,736	945,678
General and administrative	1,159,410	1,242,824
Depletion, depreciation and accretion	589,477	905,864
Stock based compensation (note 10(e))	109,560	-
Bad debt expense	5,917	-
Interest	153,166	112,390
Foreign exchange loss	9,036	46,068
	<b>2,637,302</b>	<b>3,252,824</b>
<b>Net operating loss</b>	<b>(1,568,720)</b>	<b>(1,981,491)</b>
<b>Other income and (expenses)</b>		
Equity income of Production Resources Inc. (note 6)	3,103	-
Natural gas derivative revenue (note 13(c))	113,616	-
Unrealized (loss) on financial contract (note 13(c))	(153,767)	-
Interest income	9,731	11,064
<b>Net (loss) before income tax</b>	<b>(1,596,037)</b>	<b>(1,970,427)</b>
<b>Future income tax recovery (note 11)</b>	<b>153,750</b>	<b>336,000</b>
<b>Net loss and comprehensive loss for the year</b>	<b>(1,442,287)</b>	<b>(1,634,427)</b>
<b>Deficit, beginning of year</b>	<b>(6,102,319)</b>	<b>(4,467,892)</b>
<b>Deficit, end of year</b>	<b>(7,544,606)</b>	<b>(6,102,319)</b>
<b>Basic and diluted loss per share (note 10(h))</b>	<b>(0.03)</b>	<b>(0.05)</b>
<b>Weighted average shares outstanding during the year</b>	<b>51,522,083</b>	<b>37,758,761</b>

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, 2010 and 2009

(Audited - expressed in Canadian dollars)

	2010	2009
	\$	\$
<b>Cash flows provided used in operating activities:</b>		
Net loss for the year	(1,442,287)	(1,634,427)
Items not affecting cash:		
Amortization of license fee	11,835	9,754
Depletion, depreciation and accretion	577,642	896,110
Stock based compensation	109,560	-
Equity income of Production Resources Inc.	(3,103)	-
Unrealized loss on financial contracts	153,767	-
Future income tax recovery	(153,750)	(336,000)
Asset retirement payments	-	(18,450)
	<u>(746,336)</u>	<u>(1,083,013)</u>
Changes in non-cash working capital		
Change in accounts receivable	297,452	435,594
Change in prepaid expenditures	28,630	(5,707)
Change in accounts payable and accrued liabilities	(978,675)	488,628
	<u>(1,398,929)</u>	<u>(164,498)</u>
<b>Cash flows used in investing activities</b>		
Purchase of property and equipment	(680,762)	(1,262,675)
Decrease in short-term investment	4,875	-
Sale of interest in Production Resources Inc.	214,500	-
Changes in accounts payable and accrued liabilities	923,061	-
	<u>461,674</u>	<u>(1,262,675)</u>
<b>Cash flows provided by financing activities</b>		
Private placement, net of issue costs	559,125	569,725
Receipt of related party receivable	11,865	-
Receipt of bank loan	400,000	660,019
Repayment of bank loan	(60,019)	-
Receipt of long term debt	-	80,998
Repayment of long term debt	(18,110)	-
Change in accounts receivable	(60,000)	-
	<u>832,861</u>	<u>1,310,742</u>
<b>Change in cash</b>	<u>(104,394)</u>	<u>(116,431)</u>
<b>Cash, beginning of year</b>	<u>142,728</u>	<u>259,159</u>
<b>Cash, end of year</b>	<u>38,334</u>	<u>142,728</u>
<b>Supplemental cash flow information:</b>		
Interest paid	144,405	112,390
Interest received	9,731	11,064
The Company conducted non-cash financing activities as follows:		
Fair value of agent options	5,666	4,775
Fair value of shares issued in PRI transaction	400,000	-
Property and equipment acquired through long-term debt financing	49,176	85,869

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

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the years ended December 31, 2010 and 2009**

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(Audited - 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.

## **2 Going concern**

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 December 31, 2010, the Company had not yet achieved profitable operations, had accumulated a deficit of \$7,544,606 since its inception (December 31, 2009 - \$6,102,319) and had a working capital deficiency of \$1,764,461 (December 31, 2009 - \$1,396,927) (excluding the outstanding 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.

Subsequent to December 31, 2010 the Company closed a private placement through the issuance of 9,413,701 units for aggregate gross proceeds of \$470,685 (note 18).

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the years ended December 31, 2010 and 2009**

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(Audited - expressed in Canadian dollars)

## **3 Significant accounting policies**

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") and reflect the following significant accounting policies:

### **Estimates by management**

Estimates by management represent an integral component of these financial statements prepared in accordance with Canadian GAAP. The estimates made in these financial statements reflect management's judgments based on past experiences, present conditions, and expectations of future events. Where estimates were made, the reported amounts for assets, liabilities, revenues and expenses may differ from the amounts that would otherwise be reflected if the ultimate outcome of all uncertainties and future events were known at the time these financial statements were prepared.

The Company uses estimates to calculate depreciation, depletion and accretion expense, to assess impairment of long-lived assets, to estimate asset retirement obligations, to calculate the fair value of stock options, and to estimate future tax expense.

### **Measurement uncertainty**

The Company calculated depreciation, depletion and accretion expense and calculates the ceiling test using management estimates of oil and gas reserves remaining in oil and gas properties, commodity prices and capital costs required to develop those reserves. Estimates of volumes and the related future cash flows are subject to measurement uncertainty. Such reserve estimates are subject to change as additional information becomes available.

Numerous assumptions and judgments are required in the fair value calculation of the asset retirement obligation ("ARO") including the ultimate settlement amounts, inflation factors, credit adjusted discount rates, timing of settlement, and changes in the legal, regulatory, environment and political environments. To the extent future revisions to these assumptions impact the fair value of any existing ARO liability, a corresponding adjustment is made to the oil and gas property.

The assumptions used in the determination of the fair value of stock options issued are based on the use of the Black-Scholes pricing model, which includes estimates of the future

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## ***Note 3: Significant accounting policies – continued***

### ***Measurement uncertainty - continued***

volatility of the Company's stock price, expected lives of the stock options, expected dividends and other relevant assumptions.

By their nature, these estimates are subject to measurement uncertainty, and the impact of differences between actual and estimated amounts on the financial statements of future periods could be material.

### **Cash and cash equivalents**

Cash and cash equivalents include cash and highly liquid investments held in the form of high quality commercial paper, bankers' acceptances, money market investments and certificates of deposit with investment terms that are less than three months at the time of acquisition. These investments are stated at fair value, which approximates cost plus accrued interest.

### **Joint interests**

Substantially all of the Company's oil and gas operations are conducted jointly with other parties and accordingly, the financial statements reflect only the Company's proportionate interest in these assets and operations.

### **Property, plant and equipment**

#### **(i) Petroleum and natural gas properties**

The Company follows the full cost method of accounting whereby all costs related to the acquisition are initially capitalized on a country by country cost centre basis. Costs capitalized include land acquisition costs, geological and geophysical expenditures, lease rentals on undeveloped properties, costs of drilling productive and non-productive wells, together with overhead and interest directly related to exploration and development activities, and lease and well equipment.

Gains or losses are not recognized upon disposition of petroleum and natural gas properties unless such a disposition would alter the rate of depletion and depreciation by more than 20%.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## ***Note 3: Significant accounting policies – continued***

### ***Property, plant and equipment - continued***

(ii) Depletion

Costs capitalized are depleted and amortized on a cost centre basis using the unit-of-production method based on estimated proved petroleum and natural gas reserves before royalties as determined by independent engineers. For purposes of this calculation, petroleum and natural gas reserves before royalties are converted to a common unit of measure on the basis of their relative energy content where one barrel of oil or liquids equals six thousand cubic feet of gas.

In determining its depletion base, the Company includes estimated future capital costs to be incurred in developing proved reserves and excludes the cost of significant unproved properties until it is determined whether proved reserves are attributable to the unproved properties or impairment has occurred. Unproved properties are evaluated separately for impairment based on management's assessment of future drilling.

(iii) Ceiling test

Under the full cost method of accounting, a limit is placed on the carrying amount of petroleum and natural gas properties. A ceiling test is performed on a country by country cost centre basis to recognize and measure impairment, if any.

Impairment is recognized if the carrying amount of petroleum and natural gas properties, less the cost of unproved properties not subject to depletion (the "adjusted carrying amount"), exceeds the estimated undiscounted future cash flows from the Company's proved reserves. The future cash flows are based on forecast prices and costs, as provided by an independent third party. If recognized, the magnitude of the impairment is measured by comparing the adjusted carrying amount to the estimated, discounted future cash flows of the Company's proved plus probable reserves. Any recognized impairment is recorded as additional depletion and amortization expense.

(iv) Other assets

Other assets are carried at cost and amortized over the estimated useful lives of the assets at various rates per annum calculated on a declining balance basis. Amortization is charged at half rates in the year of acquisition.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## ***Note 3: Significant accounting policies - continued***

### **Asset retirement obligation**

The Company recognizes the fair value of an asset retirement obligation ("ARO") in the period in which a well or related asset is drilled, constructed or acquired and when a reasonable estimate of the fair value can be made. The fair value of the estimated ARO is recorded as a long-term liability, and equals the present value of estimated future cash flows, discounted using a risk-free interest rate adjusted for the Company's credit standing. The liability accretes until the date of expected settlement of the retirement obligations or the asset is sold and is recorded as an accretion expense. The associated asset retirement costs are capitalized as part of the carrying value of the related assets. The capitalized amount is amortized to earnings on a basis consistent with depreciation and depletion of the underlying assets. Actual restoration expenditures are charged to the accumulated obligation as incurred. Any settlements are charged to income in the period of settlement.

On a periodic basis, management will review these estimates and if changes to the estimate are required, these changes will be applied on a prospective basis, and will result in an increase or decrease to the ARO. Any difference between the actual costs incurred and the recorded liability is recorded as a gain or loss in the statement of loss, comprehensive loss and deficit in the period in which the settlement occurs.

### **Goodwill**

The excess of the cost of acquired enterprises over the net of the amounts assigned to assets acquired and liabilities assumed is included in goodwill. These costs are not amortized but are tested for impairment annually, or more frequently, if events or changes in circumstances indicate impairment.

### **Income taxes**

Income taxes are accounted for using the liability method of income tax allocation. Under the liability method, future income tax assets and liabilities are recorded to recognize future income tax inflows and outflows arising from the settlement or recovery of assets and liabilities at their carrying values. Future income tax assets are also recognized for the benefits from tax losses and deductions that cannot be identified with particular assets or liabilities, provided those benefits are more likely than not to be realized. Future income tax assets and liabilities are determined based on the substantively enacted tax laws and rates that are anticipated to apply in the period of realization.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## ***Note 3: Significant accounting policies - continued***

### **Revenue recognition**

Revenue from the sale of petroleum and natural gas is recorded on a gross basis when title passes to an external party and is recognized based on volumes delivered to customers at contractual delivery points and rates and when the significant risks and rewards of ownership have been transferred to the buyer and collectability is reasonably assured.

### **Flow-through common shares**

Capital includes flow-through shares issued pursuant to certain provisions of the Income Tax Act (the "Act"). Under the Act, where proceeds are used for eligible capital expenditures, the related income tax deductions may be renounced to subscribers. The future income tax liabilities are increased and share capital is decreased by the tax effect of the renounced tax deductions when the expenditures are renounced provided there is reasonable assurance that the expenditures will be made.

### **Stock-based compensation**

The Company has established a stock option plan for the benefit of full-time and part-time employees, officers, directors and consultants of the Company.

The fair value of all stock options granted by the Company is recorded as a charge to the statement of loss, comprehensive loss and deficit and a credit to contributed surplus. The vesting period of the stock options is determined by the Board of Directors of the Company, and the fair value of stock options is calculated on the date of grant. Any consideration received on the exercise of stock options together with the related portion of contributed surplus is credited to share capital. The fair value of stock options is estimated using the Black-Scholes option pricing model.

### **Earnings (loss) per share**

Earnings (loss) per share is determined using the weighted average number of shares outstanding during the year. Diluted earnings (loss) per share are determined using the treasury stock method. Under this method, the dilutive effect of earnings (loss) per share is recognized on the use of proceeds that could be obtained from exercise of options, warrants and similar instruments. It assumes that proceeds would be used to purchase common shares at the average market price during the period.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## ***Note 3: Significant accounting policies - continued***

### **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.

### **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.

### **Foreign currency translations**

Transactions 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 are translated into their Canadian dollar equivalents at the exchange rates in effect on the balance sheet date. Gains and losses on translation or settlement are included in the determination of net income for the current year.

### **Financial instruments**

The financial statements have been prepared in accordance with CICA Handbook Section 1530: Comprehensive Income, CICA Handbook Section 3251: Equity, CICA Handbook Section 3855: Financial Instruments – Recognition and Measurement, CICA Handbook Section 3862: Financial Instruments – Disclosures, CICA Handbook Section 3863: Financial Instruments – Presentation, and CICA Handbook Section 3865: Hedges. These Sections provide comprehensive requirements for the recognition and measurement of financial instruments, as well as standards on when and how hedge accounting may be applied. CICA Handbook Section 1530 also establishes standards for reporting and displaying comprehensive income. Comprehensive income is defined as the change in equity from transactions and other events from non-owner sources. Other comprehensive income refers to items recognized in comprehensive income but that are excluded from net income calculated in accordance with generally accepted accounting principles.

Under CICA Handbook Section 3855, all financial instruments are classified into one of the following five categories: held-for-trading, held-to-maturity investments, loans and receivables, available for sale financial assets or other financial liabilities. All financial instruments and derivatives are measured on the balance sheet date at fair value upon

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## ***Note 3: Significant accounting policies – continued***

### ***Financial instruments - continued***

initial recognition. Subsequent measurement depends on the initial classification of the instrument. Held-for-trading financial assets are measured at fair value, with changes in fair value recognized in net earnings (loss). Available for sale financial instruments are measured at fair value, with changes in fair value recorded in OCI until the instrument is derecognized or impaired. Loans and receivables, held-to-maturity investments and other financial liabilities are measured at amortized cost.

All derivative instruments, including embedded derivatives, are recorded in the balance sheet at fair value unless they qualify for the normal sales and purchases exemption. Changes in the fair value of derivatives that are not exempt are recorded in net earnings (loss). Derivatives that qualify as hedging instruments must be designated as either a “cash flow hedge,” when the hedged item is a future cash flow, or a “fair value hedge,” when the hedged item is a recognized asset or liability. The unrealized gains and losses of the effective portion related to a cash flow hedge are included in other comprehensive income. For a fair value hedge, both the derivative and the hedged risk of the hedged item are recorded at fair value in the balance sheet and the unrealized gains and losses from both items are recorded in net earnings (loss). Any derivative instrument that does not qualify for hedge accounting is marked-to-market at each reporting date and the gains or losses are included in income.

### **Derivative financial instruments**

Derivative financial instruments are currently used by the Company to manage its exposure to market risk associated with fluctuations in commodity prices. The Company’s policy is not to utilize derivative financial instruments for speculative trading purposes. These derivative instruments do not qualify as hedges under hedge accounting guidelines. These derivative instruments are recorded at their fair values in which the value of the instruments is recorded on the balance sheet as either an asset or liability with changes in fair value recognized in the statement of operations, comprehensive loss and deficit. Realized gains and losses from financial derivatives are recognized as they occur. Unrealized gains and losses are recognized in the statement of operations, comprehensive loss and deficit at each respective reporting period. The fair value and credit risk of these transactions is based upon the estimated amounts that would have been paid to or received from counter parties to settle the transactions outstanding within reference to the estimated forward prices as of the date of the balance sheet.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## ***Note 3: Significant accounting policies – continued***

### ***Financial instruments - continued***

Upon adoption of these standards, the Company has designated its cash and cash equivalents as held for trading, which are measured at fair value. Accounts receivable are designated as loans and receivables, which are measured at amortized cost. Short-term investments are designated as held for trading. Accounts payable and accrued liabilities and operating loans are designated as other financial liabilities, which are measured at amortized cost.

#### **Capital disclosures**

CICA Handbook Section 1535 specifies the disclosure of (i) an entity's objectives, policies, and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and (iv) if it has not complied, the consequences of such non-compliance.

## **4 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.

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the years ended December 31, 2010 and 2009**

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(Audited - expressed in Canadian dollars)

## **5 Future accounting and reporting changes**

### **International Financial Reporting Standards (“IFRS”)**

The changeover to IFRS from GAAP will be required for publicly accountable enterprises effective for the interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The adoption date of January 1, 2011 will require the restatement for comparative purposes, of amounts reported by the Company for the year ended December 31, 2010, including the opening balance sheet at January 1, 2010. The transition from current GAAP to IFRS is a significant undertaking that may materially affect the Company’s reported financial position and results of operations.

The Company has identified key differences that will impact the financial statements as follows:

1. Re-classification of Exploration and Evaluations (“E&E”) expenditures from Property and Equipment
2. Calculation of depletion expense for Property and Equipment
3. Impairment of Property and Equipment
4. Provisions – decommissioning liabilities (Asset retirement obligation)
5. Share-based payments
6. Flow-through shares

At this time, the Company continues to follow existing GAAP requirements.

### **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 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

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

***Note 5: Future accounting and reporting changes – continued***

***Business Combinations, Consolidated Financial Statements and Non-controlling Interest - continued***

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 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.

## **6 Equity investment**

On March 4, 2010, the Company announced that it had acquired 50% of the shares of a private Texas based oil company, Production Resources Inc ("PRI"). 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.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

(Audited - expressed in Canadian dollars)

## Note 6: Equity investment - continued

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 December 31, 2010 is as follows:

	<b>CDN\$</b>
Purchase of 50% interest in PRI	437,919
Disposition of 50% interest in PRI to PrivateCo	(214,750)
Share of income for the period	3,103
Net investment	<u>226,272</u>

## 7 Property and equipment

	<b>2010</b>		
	<b>Cost</b>	<b>Accumulated depletion &amp; depreciation</b>	<b>Net book value</b>
	\$	\$	\$
Oil and gas properties	10,305,581	5,180,182	5,125,399
Other	298,732	172,991	125,741
	<u>10,604,313</u>	<u>5,353,173</u>	<u>5,251,140</u>
	<b>2009</b>		
	<b>Cost</b>	<b>Accumulated depletion &amp; depreciation</b>	<b>Net book value</b>
	\$	\$	\$
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>

As of December 31, 2010, the cost of petroleum and natural gas properties includes \$nil (December 31, 2009 - \$117,000) relating to unproved properties which have been excluded from costs subject to depletion and depreciation. Future development costs of \$825,000 (December 31, 2009 - \$1,091,000) have been included in the depletion calculation.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## **Note 7: Property and equipment - continued**

The Company performed a ceiling test calculation at December 31, 2010 to assess the recoverable value of oil and gas properties and equipment. Impairment is indicated if the carrying value of the long-lived asset is not recoverable from the future undiscounted cash flows. If impairment is indicated, the amount by which the carrying value exceeds the estimated discounted fair value of the long-lived asset is charged to earnings. For the year ended December 31, 2010, an impairment of the oil and gas property and equipment was calculated to be \$nil (December 31, 2009 - \$289,171). The future commodity prices used in the impairment test were based on the December 31, 2010 commodity price forecasts of the Company's independent reserve engineers.

The following table outlines benchmark prices used in the impairment test at December 31, 2010:

Year	WTI (USD/bbl)	AECO-C (CDN/Mmbtu)	Edmonton Propane (CDN/bbl)
2011	88.00	4.16	54.32
2012	87.25	4.74	56.25
2013	86.51	5.31	57.28
2014	86.69	5.77	58.56
2015	87.92	6.22	60.60

Prices increased at a rate of approximately 2% across all products per year after 2015 until the end of the reserve life.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## 8 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.

As at December 31, 2010, the Company estimated the total undiscounted amount of cash flows required to settle its ARO to be \$279,130 (December 31, 2009 - \$312,558), which are estimated to be incurred over the next 20 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 \$176,768 (December 31, 2009 - \$131,757).

	2010	2009
	\$	\$
Balance, beginning of year	<b>131,757</b>	104,942
Liabilities incurred	<b>47,389</b>	39,971
Liabilities discharged	-	(18,450)
Revision in cost estimate	<b>(12,260)</b>	(5,300)
Accretion	<b>9,882</b>	10,594
Balance, end of year	<b>176,768</b>	131,757

## 9 Bank Loan

The Company has a \$3,000,000 (December 31, 2009 - \$3,250,000) revolving operating demand loan (the "Revolving Loan"), of which \$2,875,000 (December 31, 2009 - \$2,935,019), has been drawn at December 31, 2010. Interest on the Revolving Loan is calculated daily and payable monthly on the outstanding principal amount drawn at a rate per annum equal to the bank's prime rate plus 2.00% (December 31, 2009 - bank's prime rate plus 1.50%).

The Company is subject to a standby fee of 0.25% per annum on the undrawn portion of the Revolving Loan, which is payable monthly. The Company is also subject to an issue fee of 2.00% per annum of the issued amount, which is payable at the time of issue.

During the year ended December 31, 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 daily and payable monthly on the outstanding principal amount at a rate per annum equal to the bank's prime rate plus 2.50%. The full amount has been drawn as at December 31, 2010.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

(Audited - expressed in Canadian dollars)

## Note 9: Bank Loan - continued

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 bank has required to the Company submit to them certain reports and to maintain certain covenants, which the Company is in violation of as at December 31, 2010 (note 14). The bank has not made demand of the Company's credit facilities but retains the right to do so.

## 10 Share Capital

### a) Authorized

Unlimited number of common shares with voting rights.

Unlimited number of preferred shares, issuable in series.

### b) Issued

	Number of Common Shares	Amount \$
<b>Outstanding, December 31, 2008</b>	37,034,446	5,681,646
Tax effect of flow-through shares	-	(336,000)
Private placement (i)	8,125,000	570,000
Share issue costs	-	(66,050)
Share subscription receivable	-	(19,000)
<b>Outstanding, December 31, 2009</b>	45,159,446	5,830,596
Funds received pursuant to prior year private placement	-	19,000
Shares issued on purchase of PRI(ii)	5,000,000	400,000
Tax effect of flow-through shares(i)	-	(153,750)
Private placement (iii)	8,850,000	442,500
Value of warrants issued pursuant to private placement (iii)	-	(5,863)
Private placement (iv)	4,300,000	215,000
Share subscription receivable	-	(60,000)
Value of warrants issued pursuant to private placement (iv)	-	(7,473)
Share issue costs (v)	-	(60,894)
<b>Outstanding, December 31, 2010</b>	<b>63,309,446</b>	<b>6,619,116</b>

- (i) On November 20, 2009 and December 31, 2009, the Company completed a private placement through the issuance of 6,250,000 units and 1,875,000 units (the "Unit"), respectively, for total proceeds of \$650,000 (\$0.08/unit). Each unit consists of one

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## **Note 10: Share capital - continued**

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 \$0.15 per share, exercisable for 1 year from the date of issuance. Of the total units issued, 5,812,500 and 1,875,000, respectively, were issued as a FTS. The Company allocated an aggregate of \$80,000 of the unit value received from both placements to the warrants (note 10(c)). An aggregate share issue cost for both placements was \$66,050, which included 477,500 finders options granted to those who facilitated the private placement valued at \$4,775 (note 10(f)).

Pursuant to these private placements, the Company committed to incur \$615,000 on qualifying exploration and development expenditures prior to December 31, 2010. The Company 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 \$153,750 has been recorded in the year ended December 31, 2010. As at December 31, 2010 the Company fulfilled its commitment pursuant to this placement.

- (ii) 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 (note 6).
- (iii) The Company completed a private placement ("Placement A"), issuing 8,850,000 units for total proceeds of \$442,500, (\$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 A"). 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 Placement A. Of the total 8,850,000 units issued, 6,900,000 were issued as a FTS. The Company has allocated \$5,863 of the unit value to warrants (note 10(c)).
- (iv) The Company completed a private placement ("Placement B"), issuing 4,300,000 units for total proceeds of \$215,000, (\$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

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## **Note 10: Share capital - continued**

one Warrant A. Of the total 4,300,000 units issued, 1,300,000 were issued as a FTS. The Company has allocated \$7,474 of the unit value to warrants (note 10(c)).

- (v) Pursuant to Placement A and Placement B, the Company incurred \$55,228 in cash share issue costs and issued 750,000 finders options (the "Finders Options") valued at \$5,666 (note 10(f)).

### c) Warrants

Warrants to acquire common shares outstanding at December 31, 2010 and 2009 are as follows:

	Number of warrants issued and exercisable	Amount \$	Weighted average exercise price \$	Weighted average Remaining life (years)
<b>Balance, December 31, 2008</b>	1,500,000	22,083	0.15	0.33
Share purchase warrants (10(b)(i))	8,125,000	80,000	0.15	0.91
<b>Balance, December 31, 2009</b>	9,625,000	102,083	0.15	0.14
Share purchase warrants (10b(iii) and (iv))	13,150,000	13,336	0.12	0.83
Expiry of warrants	(9,625,000)	(102,083)	0.15	-
<b>Balance, December 31, 2010</b>	13,150,000	13,337	0.12	0.83

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

	2010	2009
Risk-free rate	1.50%	1.50%
Expected life	1 year	1 year
Expected volatility	61.93%	55.00%
Fair value per warrant	\$0.001	\$0.009

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

(Audited - expressed in Canadian dollars)

## Note 10: Share capital - continued

### 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.

During the year ended December 31, 2010, the Company granted 3,450,000 stock options, 550,000 options expired unexercised, 690,000 stock options were cancelled and there were no exercises. The following table summarizes information about the Company's stock options outstanding at December 31, 2010:

	2010		2009	
	Number of options	Weighted Average Exercise price \$	Number of options	Weighted Average Exercise price \$
<b>Employee, Directors, Consultants</b>				
Stock options, beginning of year	1,850,000	0.24	2,275,000	0.26
Granted	3,450,000	0.10	-	-
Cancelled	(690,000)	0.15	-	-
Expired	(550,000)	0.25	(425,000)	0.32
Stock options outstanding, end of year	4,060,000	0.14	1,850,000	0.24

The total stock options outstanding at December 31, 2010 are as follows:

Exercise prices	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price (\$)
\$0.10	3,060,000	4.02	0.10
\$0.25	1,000,000	0.04	0.25
	4,060,000	3.40	0.14

As at December 31, 2010 all outstanding options have vested and are exercisable.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

(Audited - expressed in Canadian dollars)

## Note 10: Share capital – continued

### e) Stock based compensation

During the year ended December 31, 2010, the Company granted 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 of which expire 5 years after the grant date. The fair value of 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 year ended December 31, 2010 was \$109,560 (December 31, 2009 - \$nil), all of which has been recorded as an offsetting credit to contributed surplus.

### f) Finders Options

During the year ended December 31, 2010, the Company issued 750,000 Finders Options to the Finders who facilitated Placement A and Placement B (note 10(b)(v)) (2009 – 477,500), and 1,090,617 FINDER Options expired unexercised. Each Finders Option granted during the year 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 one year from the original grant date.

The following table summarizes information about the Company’s Finder Options outstanding at December 31, 2010:

	2010		2009	
	Number of options	Weighted Average Exercise price \$	Number of options	Weighted Average Exercise price \$
Agent Options, beginning of year	1,090,617	0.12	613,117	0.15
Granted	750,000	0.05	477,500	0.08
Expired	(1,090,617)	(0.12)	-	-
Agent Options outstanding, end of year	750,000	0.05	1,090,617	0.12

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## **Note 10: Share capital – continued**

### **Finders Options - continued**

The Finders Options were valued at \$5,666. 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:

	<b>2010</b>	<b>2009</b>
Risk-free interest rate	1.44%	1.50%
Expected life	1 years	1 year
Expected volatility	61.93%	55.00%
Fair value per option	0.01	0.01

### **g) Contributed surplus**

	<b>2010</b>	<b>2009</b>
<b>Balance, beginning of year</b>	766,924	762,149
Stock based compensation expense (note 10(e))	109,560	-
Agent options (note 10(f))	5,666	4,775
Warrants expired unexercised (note 10(c))	102,083	-
<b>Balance, end of year</b>	<u>984,233</u>	<u>766,924</u>

### **h) Diluted (loss) earnings per share**

Basic earnings per share are calculated based on the weighted average number of shares outstanding during the year ended December 31, 2010 of 51,522,083 (2009 – 37,758,761). 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 years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## 11 Income taxes

- a) The significant components of the Company's future tax assets and liabilities are as follows:

	2010	2009
	\$	\$
Oil and gas properties and equipment, ARO, license fee	(245,000)	(253,000)
Non-capital loss carry-forwards	704,000	504,000
Share issuance costs	43,000	55,000
Scientific research and experimental development	151,000	151,000
Investment tax credits	195,000	195,000
Attributed Canadian royalty income	110,000	110,000
Valuation allowance	(958,000)	(762,000)
	<hr/>	<hr/>
	-	-

- b) The Company has estimated tax pools totaling:

	Rate of Claim	2010
Canadian exploration expense	100%	1,224,000
Canadian development expense	30%	1,212,000
Canadian oil and gas property expense	10%	89,000
Foreign exploration and development expense	100%	290,600
Undepreciated capital cost	Various	1,270,000
Share issue costs	20%	173,000
Non-capital losses		2,815,000
Scientific research and experimental development		602,700
Attributed Canadian royalty income		1,100,800
		<hr/>
		8,777,100

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

(Audited - expressed in Canadian dollars)

## Note 11: Income tax – continued

c) A reconciliation between the Company's statutory and effective tax rate is as follows:

	2010	2009
	\$	\$
Net loss before income taxes	(1,596,037)	(1,970,427)
Enacted rate	28%	29%
Computed income taxes as enacted rate	(446,900)	(571,000)
Increase decrease in tax resulting from:		
Future tax differences	28,150	78,000
Non-deductible expenses	69,000	(7,000)
Other	-	(25,000)
Change in valuation allowance	196,000	189,000
Recovery of future income taxes	(153,750)	(336,000)

## 12 Related parties

a) The following amounts are due by related parties:

	2010	2009
	\$	\$
Note receivable from officer (i)	225,054	218,500
Fair value allowance (ii)	(206,710)	(206,710)
Net note receivable	18,344	11,790
Advance fees (iii)	33,029	51,448
	51,373	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 \$19,650 at December 31, 2010 (December 31, 2009 - \$35,370).

(ii) The fair value allowance was determined in 2008, based on the market value of the secured shares at December 31, 2008. The Company has not provided an additional allowance to the estimated fair value of the 393,000 common shares held as security as the fair value at December 31, 2010 and 2009 exceeded the carrying amount.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## **Note 12: Related parties - continued**

- (iii) During the year ended December 31, 2008, a director was advanced \$59,473 in relation to efforts to finance and advance the Company's drilling technology. At December 31, 2010 \$33,029 (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. During the year ending December 31, 2010, the original repayment date of December 31, 2010 was extended to December 31, 2011.
  
- b) Related party transactions not disclosed elsewhere in these financial statements are as follows:
  - (i) Aggregate fees of \$85,000 (December 31, 2009 - \$187,319) were charged by officers of the Company. Of this amount \$24,100 (December 31, 2009 - \$187,319) was recorded in the statement of operations, comprehensive loss and deficit and \$60,900 (December 31, 2009 - \$nil) was capitalized to property, plant and equipment.
  
  - (ii) Aggregate consulting fees of \$256,500 (December 31, 2009 - \$276,569) were charged by directors and officers of the Company and were expensed as general and administrative expenses.
  
  - (iii) Aggregate legal fees of \$7,854 (December 31, 2009 - \$33,200) 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.
  
  - (iv) Aggregate fees of \$43,200 (December 31, 2009 - \$77,000) 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.
  
  - (v) Included in accounts payable at December 31, 2010 was \$51,636 owing to related parties of the Company and \$114,976 owing to the Company from related parties.

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

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## 13 Financial Instruments and Risk Management

### a) Fair values

At December 31, 2010, the Company's financial instruments consist of cash and cash equivalents, accounts receivable, the bank loan and accounts payable and accrued liabilities. The fair values of these financial instruments approximate their carrying value due to their short-term nature.

The Company has classified the 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 December 31, 2010, the Company's cash and cash equivalents and the equity investment have been assessed based on the fair value hierarchy above. Cash and cash equivalents and short-term investments are assessed through level 1, 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.

### 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, and the concentration risk within

# Emerald Bay Energy Inc.

Notes to the Financial Statements

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(Audited - expressed in Canadian dollars)

## **Note 13: Financial instruments – continued**

### ***Credit risk - continued***

the accounts receivable balance is minimal. The Company has experienced \$5,917 in credit loss in the collection of accounts receivable in the year ended December 31, 2010 (December 31, 2009 - \$nil).

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 the year ending December 31, 2010 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.

The Company's derivative financial instrument was classified as held-for-trading and the reported fair value changes during the year were recorded through the statement of operations, comprehensive loss, and deficit. The realized gain recorded by the Company on the derivative financial instrument for the year ended December 31, 2010 was \$113,616.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## **Note 13: Financial instruments – continued**

### **Market risk, commodity price risk – continued**

On October 27, 2010, the Company entered into a derivative financial instrument, which becomes effective on January 1, 2011 to December 31, 2011 (“Option A”). This instrument fixes the received price of natural gas at CDN 4.684 per GJ. As at December 31, 2010, the Company has recorded an unrealized gain in the statement of operations, comprehensive loss and deficit of \$162,458. The unrealized gain represents the market value of the contract as at December 31, 2010.

On October 28, 2010, the Company entered into two commodity call options. The first option (“Option B”) is effective from January 1, 2011 to December 31, 2011 and the second option (“Option C”) is effective from January 1, 2012 to December 31, 2012. Both Options have a strike price of USD \$90.00 per BBL. As at December 31, 2010, the Company has recorded an unrealized loss in the statement of operations, comprehensive loss and deficit of \$316,224.

The following table summarizes the fair value of the Options as at December 31, 2010:

	Short-term	Long-term
Option A	162,458	
Option B	(165,736)	
Option C		(150,488)
Financial contract, December 31, 2010	(3,278)	(150,488)

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 \$103,100 increase or decrease in the Petroleum and Natural Gas sales for the year ended December 31, 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 the bank’s prime rate plus 2.00% and prime plus 2.50%, respectively. An estimated 1.00% increase or decrease in the interest rate would have affected the Company’s statement of operations by \$29,000 for year ended December 31, 2010.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## **Note 13: Financial instruments – continued**

### **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 December 31, 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 \$5,170 impact on the Company's earnings for the year.

### **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.

# Emerald Bay Energy Inc.

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(Audited - expressed in Canadian dollars)

## **Note 13: Financial instruments – continued**

### **Liquidity risk - continued**

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	\$1,764,461	This amount is anticipated to be met out of additional share issuance in the 2011 fiscal period.
Bank loan (note 9)	\$3,275,000	The Company anticipates issuing additional share capital to reduce this amount in 2011. 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 year.
Long term debt	\$89,989	Vehicle loans will be paid over 5 years out of normal cash flow.

## **14 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.

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 December 31, 2010, the Company was in violation of this bank covenant with a ratio of

# **Emerald Bay Energy Inc.**

Notes to the Financial Statements

**For the years ended December 31, 2010 and 2009**

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(Audited - expressed in Canadian dollars)

## ***Note 14: Capital management – continued***

0.38:1. 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.

## **15 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 principal repayments for fiscal years 2011 through to 2015 are respectively as follows: \$22,075, \$23,345, \$24,688, \$26,110 and \$15,846.
- 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 \$410,000 of expenditures that qualify as CEE for Canadian income tax purposes and to incur these expenditures no later than December 31, 2011.

## **16 Contingencies**

During 2008, an oilfield service provider commenced legal action against the Company regarding disputed cost overruns during drilling operations that totalled \$110,675. During 2009 the Company counterclaimed for \$246,437, plus additional damages. Management maintains that at this time, the outcome of this action is not determinable and as the Company has only an 18% interest in the action, the outcome will have no material impact on the Company. During the year ended December 31, 2010, neither party pursued the claim.

# Emerald Bay Energy Inc.

Notes to the Financial Statements

For the years ended December 31, 2010 and 2009

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(Audited - expressed in Canadian dollars)

## 17 Segmented information

The Company's primary operations are limited to a single industry being the acquisition, exploration for, and development of petroleum and natural gas. Geographical segmentation is as follows:

			<b>2010 (\$)</b>
	<b>Canada</b>	<b>United States</b>	<b>Total</b>
Petroleum and natural gas sales	1,200,409	111,276	1,311,685
Interest income	9,731	-	9,731
Depletion, depreciation and accretion	531,295	58,182	589,477
Net loss	1,292,304	149,983	1,442,287
Property and equipment	4,953,443	297,697	5,251,140
License	-	-	-

  

			<b>2009 (\$)</b>
	<b>Canada</b>	<b>United States</b>	<b>Total</b>
Petroleum and natural gas sales	1,386,197	101,598	1,487,795
Interest income	11,064	-	11,064
Depletion, depreciation and accretion	379,848	526,016	905,864
Net loss	1,442,840	191,587	1,634,427
Property and equipment	4,724,809	329,024	5,053,833
License	11,835	-	11,835

## 18 Subsequent Events

Subsequent to December 31, 2010 the Company closed a private placement (the "Private Placement") pursuant to which 9,413,701 units (the "Units") were issued at a price of \$0.05 per Unit, for aggregate proceeds of \$470,685. Each Unit consisted of one common share of the Company, issued either as a common share or as a flow-through share at the subscribers option) and one share purchase warrant (the "Warrant"). Each whole Warrant is exercisable for one additional common share of the Company for a period of 18 months from the issuance of the Units at a price of \$0.10 per share. Of the total Units issued, an aggregate of 6,163,701 were issued as flow-through shares.

Cash proceeds of \$3,500 and 70,000 finder's options (the "Finder's Options") were issued to those who facilitated the private placement. Each Finder's Option entitles the holder to acquire one Unit of the Company at a purchase price of \$0.05 per Unit for a period of 12 months from the issuance of the Finder's Option.