



Emerald Bay Energy

**Emerald Bay Energy Inc.
Audited Financial Statements
For the years ended December 31, 2005 and 2004**

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Auditor's Report

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

We have audited the balance sheet of Emerald Bay Energy Inc. as at December 31, 2005 and the statements of operations and deficit and cash flows for the year 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 audit.

We conducted our audit 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, 2005 and the results of its operations and its cash flows for the year then ended, in accordance with Canadian generally accepted accounting principles.

The financial statements for the year ended December 31, 2004 were audited by another firm of chartered accountants who reported without reservation in a report dated April 27, 2005.

MacKay LLP

Chartered Accountants

Calgary, Canada
April 24, 2006

**Emerald Bay Energy Inc.
Balance Sheets**

| As at December 31 | 2005 | 2004 |
|--|---------------------|---------------------|
| Assets | | |
| Current | | |
| Cash and cash equivalents | \$ 3,203,638 | \$ 98,160 |
| Short term investments | 64,060 | - |
| Accounts receivable | 815,073 | 480,293 |
| Prepaid expenses and deposits | 2,655 | 2,655 |
| | <u>4,085,426</u> | <u>581,108</u> |
| Due from related party (Note 6) | 218,500 | 202,212 |
| Property and equipment (Note 3) | 2,329,707 | 2,056,461 |
| License | 51,471 | 61,765 |
| Deposits | 20,237 | 52,666 |
| | <u>\$ 6,705,341</u> | <u>\$ 2,954,212</u> |
| Liabilities and Shareholders' Equity | | |
| Current | | |
| Bank loan | \$ - | \$ 360,000 |
| Note payable (Note 5) | 2,000,000 | - |
| Accounts payable and accrued liabilities | 1,191,735 | 2,069,007 |
| | <u>3,191,735</u> | <u>2,429,007</u> |
| Asset retirement obligations (Note 4) | 117,021 | 97,344 |
| | <u>3,308,756</u> | <u>2,526,351</u> |
| Contingencies (Note 10) | | |
| Shareholders' equity | | |
| Share capital (Note 7(b)) | 5,695,691 | 1,991,825 |
| Contributed surplus (Note 8) | 150,351 | 22,183 |
| Deficit | (2,449,457) | (1,586,147) |
| | <u>3,396,585</u> | <u>427,861</u> |
| | <u>\$ 6,705,341</u> | <u>\$ 2,954,212</u> |

"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 Deficit

| For the years ended December 31 | 2005 | 2004 |
|--|-----------------------|-----------------------|
| Revenue | | |
| Petroleum and natural gas sales | \$ 2,320,876 | \$ 1,216,492 |
| Royalties | (618,588) | (203,977) |
| Alberta Royalty Tax Credits | 74,839 | (280,305) |
| | <u>1,777,127</u> | <u>732,210</u> |
| Expenses | | |
| Operating | 360,841 | 240,072 |
| General and administrative | 1,499,081 | 938,758 |
| Research and development | 179,790 | 440,880 |
| Depletion, amortization and accretion | 516,724 | 206,525 |
| Interest | 90,611 | 8,670 |
| | <u>2,647,047</u> | <u>1,834,905</u> |
| Income (loss) from operations | <u>(869,920)</u> | <u>(1,102,695)</u> |
| Other income | | |
| Interest | 6,610 | 10,571 |
| Income (loss) before income taxes | <u>(863,310)</u> | <u>(1,092,124)</u> |
| Income taxes (recovery) (Note 9) | | |
| Current | --- | 35,000 |
| Future | --- | (146,016) |
| | <u>---</u> | <u>(111,016)</u> |
| Loss for the year | <u>(863,310)</u> | <u>(981,108)</u> |
| Deficit, beginning of year | (1,586,147) | (605,039) |
| Deficit, end of year | <u>\$ (2,449,457)</u> | <u>\$ (1,586,147)</u> |
| Loss per common share (Note 7(d)) | | |
| | \$ (0.05) | \$ (0.08) |
| Weighted average number of shares | | |
| | 16,158,956 | 11,708,304 |

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 | 2005 | 2004 |
|--|---------------------|------------------|
| Cash flows from operating activities | | |
| Loss for the year | \$ (863,310) | \$ (981,108) |
| Adjustments for: | | |
| Depletion, amortization and accretion | 506,430 | 202,408 |
| Amortization of license fee | 10,294 | 4,117 |
| Future income taxes | - | (146,000) |
| Stock option expense | 85,710 | 22,183 |
| Alberta royalty tax credits | (74,839) | 280,305 |
| | <u>(335,715)</u> | <u>(618,095)</u> |
| Changes in non-cash operating balances | | |
| Accounts receivable | (334,780) | (288,096) |
| Prepaid expenses and deposits | 32,428 | 1,959 |
| Accounts payable | (1,383,588) | (5,896) |
| Accrued liabilities | (114,500) | (51,500) |
| | <u>(2,136,155)</u> | <u>(961,628)</u> |
| Cash flows from financing activities | | |
| Bank loan advances (repayment) | (360,000) | 360,000 |
| Advances from note payable | 2,000,000 | - |
| Related party advances (repayments) | (16,288) | 25,805 |
| Issuance of share capital, net of costs | 3,746,324 | - |
| | <u>5,370,036</u> | <u>385,805</u> |
| Cash flows from investing activities | | |
| Purchases of property and equipment | (759,998) | (1,604,339) |
| Changes in non-cash investing balances | 695,655 | 1,313,327 |
| | <u>(64,343)</u> | <u>(291,012)</u> |
| Increase (decrease) in cash and equivalents | 3,169,538 | (866,835) |
| Cash and equivalents, beginning of year | <u>98,160</u> | <u>964,995</u> |
| Cash and equivalents, end of year | \$ 3,267,698 | \$ 98,160 |

| Cash and equivalents, end of year | 2005 | 2004 |
|-----------------------------------|---------------------|------------------|
| Cash and cash equivalents | \$ 3,203,638 | \$ 98,160 |
| Short term investments | 64,060 | - |
| | <u>\$ 3,267,698</u> | <u>\$ 98,160</u> |

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

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2005 and 2004

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. Summary of Significant Accounting Policies

The financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The financial statements have, in management's opinion, been properly prepared using careful judgement with reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

a) Property and equipment

The Company follows the full cost method of accounting for oil and gas operations whereby all costs of exploring for and developing oil and gas reserves are initially capitalized. Such costs include land acquisition costs, geological and geophysical expenses, carrying charges on non-producing properties, costs of drilling and overhead charges directly related to acquisition and exploration activities.

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 significantly alter the rate of depletion.

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.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2005 and 2004

2. Summary of Significant Accounting Policies – Continued

Furniture and equipment are carried at cost and amortized over the estimated useful lives of the asset on a straight-line basis over three to five years.

b) Joint venture operations

The majority of the Company's petroleum and natural gas exploration activities are conducted jointly with others. These financial statements reflect only the Company's proportionate interest in such activities.

c) Asset retirement obligations

The company provides for asset retirement obligations for associated long-lived assets that result from the acquisition, construction, development or normal use for the assets and requires that a liability for an asset retirement obligation be recognized when incurred, recorded at fair value and classified as a liability in the balance sheet. When the liability is initially recorded, the entity will capitalize the net present value of the cost and increase the carrying value of the related long-lived asset. Asset retirement obligations represent future liabilities, and, as a result, accretion expense will be accrued on this liability until the obligation is satisfied. At the same time, the capitalized cost will be depleted over the estimated useful life of the related asset. At settlement date, the entity will settle the obligation for its recorded amount or recognize a gain or loss upon settlement.

d) Revenue recognition

Revenue associated with the sales of petroleum and natural gas production owned by the Company is recognized when the title passes from the Company to its customers. Transportation costs are not netted against revenue but included with production costs, as they are not material to show separately. Alberta Royalty Tax Credits are deducted from royalty expense. Commodities sold by the Company below or above its working interest share in the related resource properties may result in production underliftings, which is recorded in inventory. Product inventories are valued at the lower of average cost and net realizable value on a first-in, first-out basis.

e) Flow-through equity instruments

Expenditure deductions for income tax purposes related to exploratory activities funded by flow-through share/warrants arrangements are renounced to investors in accordance with income tax legislation. A future tax liability is recognized upon the renunciation of tax pools and share capital is reduced by the estimated costs of the renounced tax deductions at the time of filings with the proper tax authorities.

f) Financial instruments

The Company carries a number of financial instruments. It is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.

g) 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.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2005 and 2004

2. Summary of Significant Accounting Policies - Continued

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.

h) 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. Where uncertainty exists relating to the ability to utilize a tax asset, a valuation allowance is recorded.

i) Cash and short-term investments

Cash and short-term investments include bank balances and all highly liquid instruments purchased with an original maturity of three month or less.

j) Stock based compensation plan

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.

k) 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. The treasury stock method is used to determine the dilutive effect of stock options and other dilutive instruments, in accordance with new standards approved by the Canadian Institute of Chartered Accountants.

l) License fee

License fee relates to patent rights of certain lateral drainhole drilling technology. Commencing in 2003 this license fee was being amortized over the remaining life of the patent (17 years). If the license fee is determined not to have value, it will be written off in the period the determination is made. During the year, the Company reevaluated the period in which the benefit from the patent could be obtained and as a result shortened the amortization period to 6 years.

m) 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.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2005 and 2004

2. Summary of Significant Accounting Policies - Continued

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.

3. Property and Equipment

| | December 31, 2005 | | | December 31, 2004 | | |
|---|---------------------|--|---------------------|---------------------|--|---------------------|
| | Cost | Accumulated Depletion and Amortization | Net Book Value | Cost | Accumulated Depletion and Amortization | Net Book Value |
| Petroleum and natural gas properties | \$ 3,546,040 | \$ 1,255,821 | \$ 2,290,219 | \$ 2,795,651 | \$ 782,593 | \$ 2,013,058 |
| Furniture and Equipment | 98,236 | 58,748 | 39,488 | 88,626 | 45,223 | 43,403 |
| | \$ 3,644,276 | \$ 1,314,569 | \$ 2,329,707 | \$ 2,884,277 | \$ 827,816 | \$ 2,056,461 |

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, 2005 and determined that there was no impairment of costs requiring a write down in either of its cost centres.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2005 and 2004

4. 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 \$117,021 as at December 31, 2005 based on a total future liability of \$200,000 and incorporated the Company's credit-adjusted risk-free interest rate of 7.5%. These payments are expected to be made over the next 9 years.

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

| | <u>2005</u> |
|--|-------------------|
| Asset retirement obligation, beginning of year | \$ 97,344 |
| New liabilities incurred | - |
| Liabilities settled | - |
| Accretion expense | <u>19,677</u> |
| Asset retirement obligation, end of year | <u>\$ 117,021</u> |

| | <u>2004</u> |
|--|------------------|
| Asset retirement obligation, beginning of year | \$ 61,204 |
| New liabilities incurred | 25,600 |
| Liabilities settled | - |
| Accretion expense | <u>10,540</u> |
| Asset retirement obligation, end of year | <u>\$ 97,344</u> |

5. Note Payable

On September 15, 2005 Emerald Bay entered into an agreement with Toscana Capital Corporation and its financial partner Toscana GP Capital Inc. and obtained a \$2,000,000 bridge financing credit facility used to repay all credit facilities at the Alberta Treasury Branches and provide working capital. The loan bears interest at the rate of 12% per annum. The facility, repaid in full January 3, 2006 and is secured against the assets of the Corporation. Fees totalling \$40,000 were paid in relation to this financing.

**Emerald Bay Energy Inc.
Notes To Financial Statements**

December 31, 2005 and 2004

6. Due From Related Parties and Related Party Transactions

a) The following amounts are due by related parties:

| | Dec 31, 2005 | Dec 31, 2004 |
|----------------------------------|-------------------|-------------------|
| Due from related party | | |
| Note receivable from officer (i) | 218,500 | 202,212 |
| | \$ 218,500 | \$ 202,212 |

(i) Note receivable from officer
Promissory note bearing interest at 3% per annum and repayable by December 31, 2007. The note is secured by 393,000 common shares of the Company and a personal guarantee from another related officer of the Company. The value of the security provided to the Company at both December 31, 2005 and December 31, 2004 exceeds the book value of the promissory note.

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, 2005.

- (i) Directors and officers, have charged the Company \$ 194,800 (2004 - \$213,084) for professional and administrative services.
- (ii) A law firm in which a director is a partner has charged the Company \$ 60,745 (2004 - \$19,510) in legal fees. A majority of the legal fees were related to the short form offering and private placements that were conducted during 2005.
- (iii) A company owned 100% by a director has charged the Company \$ 220,215 (2004 - \$83,000) in consulting fees. Included in this amount is \$ 25,715 for moving and relocation expenses. A company owned and controlled by a director has charged the Company \$ 51,200 (2004 - \$72,923) with respect to the operation costs and has paid the Company \$ 97,971 (2004 - 82,809) in revenue with respect to the operations of certain wells in the USA. Included in accounts receivable is \$ 21,987 (2004 - \$45,667) related to this revenue.

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, 2005 and 2004

7. Equity Instruments

a) Authorized

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

b) Issued

| | December 31, 2005 | |
|---|---------------------|---------------------|
| | Number of Shares | Amount |
| Common shares issued and issuable for cash | | |
| Balance, beginning of year | 11,708,304 | \$ 1,949,425 |
| Private Placement (i) | 3,000,000 | 600,000 |
| Less value ascribed to warrants | | (150,000) |
| Private Placement (ii) | 2,755,556 | 620,000 |
| Less value ascribed to warrants | | (18,462) |
| Short form offering (iii) | 7,256,750 | 2,000,000 |
| Less value ascribed to warrants | | (155,782) |
| Private placement (iv) | 2,916,667 | 875,000 |
| Subscription receivable | | (34,988) |
| Share issue costs | | (389,564) |
| Balance, end of year | 27,637,277 | 5,295,629 |
| Warrants outstanding beginning of year | 1,593,798 | 42,400 |
| Warrants issued (i) | 3,160,000 | 154,720 |
| Warrants issued (ii) | 1,377,778 | 18,462 |
| Warrants issued (iii) | 3,540,500 | 207,015 |
| Warrants issued (iv) | 290,000 | 19,865 |
| Warrants expired | (1,593,798) | (42,400) |
| Balance, end of year | 8,368,278 | 400,062 |
| Equity instruments balance December 31, 2005 | | \$ 5,695,691 |

- (i) On February 18, 2005, the Company completed a private placement of 3,000,000 units at an issued price of \$0.20 per unit, for consideration of \$600,000. Each unit consists of one common share and one share purchase warrant that may be exercised to acquire additional common shares at \$0.25 per share at any time in the two years following the closing of the private placement. All of the common shares issued pursuant to the private placement are subject to a 4 month hold period. 1,757,500 units of the private placement were acquired by directors and officers of the Company. The Company incurred issuance costs of \$39,095 cash and issued 160,000 agent warrants which may be exercised to acquire additional common shares at \$0.25 per share for a one year period. The compensation expense incurred in relation to the issuance of the agent warrants is \$4,720.

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2005 and 2004

7. Equity Instruments - Continued

- (ii) On June 8, 2005, the Company completed a private placement of 2,755,556 units at an issued price of \$0.225 per unit, for consideration of \$620,000. Each unit consists of one common share and one-half of one share purchase warrant that may be exercised to acquire additional common shares at \$0.40 per share at any time in the twelve months following the closing of the private placement. All of the common shares issued pursuant to the private placement are subject to a 4 month hold period. The Company incurred issuance costs of \$18,375 cash.
- (iii) On December 19, 2005, the Company completed a Short Form Offering of an aggregate of 3,540,500 units and 3,716,250 flow-through shares for gross proceeds of \$2,000,000 (the maximum amount under this Offering). Units were priced at \$0.25 per unit and flow-through common shares were priced at \$0.30 per flow-through common share. Each unit consists of one (1) common share and one (1) warrant. Each full warrant entitles the holder to acquire one (1) common share at a price of \$0.35 for a period of twelve months from the date of issue or at a price of \$0.45 for an additional period of twelve months thereafter. A total of 2,809,584 common shares issued pursuant to the offering were subject to a four month hold period expiring on April 20, 2006. Union Securities Ltd. received a commission equal to 8% of the gross proceeds received by Emerald Bay pursuant to the Offering. In addition, Emerald Bay paid Union a corporate finance fee of \$25,000. Union and its sub agents also received agent's options to acquire an aggregate of 725,675 units (same unit terms as described above), at a price of \$0.25 per unit for a period of 18 months from the date of issue. The compensation expense incurred in relation to the issuance of the agent options is \$51,233.
- (iv) On December 29, 2005, the Company completed a private placement of 2,916,667 flow-through common shares at a price of \$0.30 per share for aggregate consideration of \$875,000. All of the shares issued pursuant to the private placement were subject to a four month hold period. Finder's fees totaled an aggregate of \$69,600. Emerald Bay also issued an aggregate of 290,000 finder's fees warrants, each warrant entitling the holder to acquire one common share in Emerald Bay at a price of \$0.30 for a period of twelve months from the date of issue. The compensation expense incurred in relation to the issuance of the agent options is \$19,865.

The assumptions for the value of the warrants are as follows:

| | |
|-----------------|-------------------------|
| Volatility | 55% |
| Term | varies from 1 – 2 years |
| Annual dividend | 0% |
| Discount rate | varies from 3 – 3.4% |

There were no share or warrant transactions in 2004

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2005 and 2004

7. Equity Instruments – continued

c) Stock options

The Company has established a stock option plan whereby the Company may grant directors, officers, employees and consultants up to a maximum of 10% of the issued common shares. The 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 2005 vest immediately.

| | December 31, 2005 | | December 31, 2004 | |
|--|-------------------|---------------------------------|-------------------|---------------------------------|
| | Number of options | Weighted average exercise price | Number of options | Weighted Average Exercise price |
| Stock options, beginning of year | 842,904 | \$ 0.27 | 620,000 | \$ 0.22 |
| Granted | 650,000 | 0.25 | 550,000 | 0.32 |
| Expired | (313,000) | (0.27) | (327,096) | (0.21) |
| Stock options outstanding, end of year | 1,179,904 | \$ 0.27 | 842,904 | \$ 0.29 |
| Exercisable, end of year | 1,003,306 | \$ 0.26 | 278,602 | \$ 0.23 |

The stock options outstanding as at December 31, 2005 are as follows:

| <u>Exercise prices</u> | <u>Options outstanding</u> | | | <u>Options exercisable</u> | | |
|------------------------|----------------------------|--|--|----------------------------|--|--|
| | <u>Options outstanding</u> | <u>Weighted average remaining term (years)</u> | <u>Weighted average exercise price</u> | <u>Options exercisable</u> | <u>Weighted average exercise price</u> | |
| \$0.19 | 104,904 | 2.1 | \$ 0.19 | 104,904 | \$ 0.19 | |
| \$0.25 | 650,000 | 4.6 | 0.25 | 650,000 | 0.25 | |
| \$0.32 | 425,000 | 3.3 | 0.32 | 248,402 | 0.32 | |
| | 1,179,904 | 3.8 | \$ 0.27 | 1,003,306 | \$ 0.26 | |

The stock options outstanding as at December 31, 2004 are as follows:

| <u>Exercise prices</u> | <u>Options outstanding</u> | | | <u>Options exercisable</u> | | |
|------------------------|----------------------------|--|--|----------------------------|--|--|
| | <u>Options outstanding</u> | <u>Weighted average remaining term (years)</u> | <u>Weighted average exercise price</u> | <u>Options exercisable</u> | <u>Weighted average exercise price</u> | |
| \$0.19 | 117,904 | 3.0 | \$ 0.19 | 78,602 | \$ 0.19 | |
| \$0.25 | 200,000 | .2 | 0.25 | 200,000 | 0.25 | |
| \$0.32 | 525,000 | 4.5 | 0.32 | | 0.32 | |
| | 842,904 | 3.3 | \$ 0.29 | 278,602 | \$ 0.23 | |

d) Diluted earnings (loss) per share

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

Emerald Bay Energy Inc.
Notes To Financial Statements

December 31, 2005 and 2004

8. Stock Compensation

On June 21, 2005 the Company granted 650,000 stock options at a price of \$0.25 per share, vesting immediately and a 5 year term. The Company recorded compensation expense when stock options were issued to employees, as disclosed in Note 6(c).

The fair value of share options was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (Nil), expected volatility (55%), risk-free interest rate of (3.4%), and weighted average life of 5 years. The estimated value of \$ 62,790 was recorded for the options granted in the year. The 2005 stock option expense of \$85,710 is included in general administration costs with a corresponding credit to contributed surplus.

9. Income Taxes

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

| | 2005 | 2004 |
|---|---------------------|---------------------|
| Combined tax rate | 37.62% | 39.12% |
| Expected income tax provision at statutory rate | \$ (324,777) | \$ (427,000) |
| Non-deductible crown charges | 128,420 | 58,000 |
| Resource allowance | (113,903) | (3,000) |
| Non-taxable Alberta royalty adjustments(Note 8) | (47,003) | 110,000 |
| Investment tax credits | 6,764 | 9,000 |
| Rate change | 22,743 | (24,000) |
| True-up | (46,596) | - |
| Valuation allowance | 374,000 | 131,000 |
| Other | 352 | - |
| Actual income tax provision | \$ (0) | \$ (146,000) |

Income tax expense for 2004 is related to the 2003 flow through share commitments.

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

| | 2005 | 2004 |
|---|-------------------|-------------------|
| Cumulative Canadian Oil and Gas Property Expenses (COGPE) | \$ 226,000 | \$ 257,000 |
| Cumulative Canadian Development Expenses (CDE) | 929,000 | 257,000 |
| Cumulative Canadian Exploration Expenses (CEE) | 73,000 | - |
| Foreign Exploration and Development Expenses (FEDE) | 213,000 | 263,000 |
| Undepreciated Capital Cost (UCC) | 174,000 | 189,000 |
| Share issue costs | 381,000 | 196,000 |
| Scientific Research and Experimental Development (SR&ED) | 791,000 | 737,000 |
| Attributed Canadian Royalty Income (ACRI) | 1,387,000 | 852,000 |
| Non-capital losses | 559,000 | 67,000 |

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9. Income Taxes – Continued

These pools are deductible from future income at rates prescribed by the Canadian Income Tax Act.

The components of the Company's future income tax asset (liability) are a result of the origination and reversal of temporary differences and are comprised of the following:

| Nature of temporary differences | 2005 | 2004 |
|--|--------------|--------------|
| Property and equipment, ARO, License Fee | \$ (218,000) | \$ (355,000) |
| Share issue costs | 128,000 | 66,000 |
| Scientific Research and Experimental Development | 181,000 | 195,000 |
| Investment tax credits | 167,000 | 104,000 |
| Attributed Canadian royalty income | 159,000 | 98,000 |
| Loss carry-forward | 188,000 | 23,000 |
| Valuation allowance | (605,000) | (131,000) |
| Future income tax (liability) asset | \$ - | \$ - |

10. Contingencies

- a) In 2000, the Company commenced legal action against a joint venturer claiming underpayment of a net profit royalty. The joint venturer has issued a counterclaim for an unspecified amount, claiming an overpayment of this royalty. In the opinion of management, the outcome of these claims is not determinable at this time. On February 24, 2006 the Company's legal counsel discontinued this claim without payment of costs by either party.
- b) In 2003, Alberta Revenue issued Notices of Reassessment to the Company disallowing claims for Alberta Royalty Tax Credits ("ARTC") made in the Alberta Corporate Income tax returns for the years 1998 – 2001. The Company disagrees with these reassessments and the Company has filed a Notice of Objection with Alberta Revenue. The final outcome of this matter is not determinable at this time.
- c) In 2005, an oilfield service provider commenced legal action against the Company relating to the loss of a tool in the well bore of one of the Company's wells. As a result of this incident the Company also incurred losses arising from fishing costs, lost production, and potential well bore damage which the Company considers part of it's possible counterclaim in regards to this action. In the opinion of management, the outcome of this action is not determinable at this time. It is also the opinion of management, that the outcome of this action would have minimal effect on the Company

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11. Segmented Information

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

| <u>2005</u> | Oil & gas production | Lateral drainhole drilling technology | Total |
|---------------------------------------|-------------------------|--|--------------|
| Petroleum and natural gas sales | \$ 2,320,876 | \$ | \$2,320,876 |
| Interest revenue | \$ 6,610 | \$ | \$ 6,610 |
| Depletion, amortization and accretion | \$ 506,430 | \$ 10,294 | \$ 516,724 |
| Interest expense | \$ 90,611 | \$ | \$ 90,611 |
| Income tax recovery | \$ - | \$ | \$ - |
| Segment loss | \$ (683,520) | \$ (179,790) | \$ (863,310) |
| Segment assets | \$ 6,653,870 | \$ 51,471 | \$6,705,341 |
| Capital expenditures | \$ 759,998 | \$ | \$ 759,998 |
| | | | |
| <u>2004</u> | Oil & gas production | Lateral drainhole drilling technology | Total |
| Petroleum and natural gas sales | \$1,216,492 | \$ | \$1,216,492 |
| Interest revenue | \$ 10,571 | \$ | \$ 10,571 |
| Depletion, amortization and accretion | \$ 202,408 | \$ 4,117 | \$ 206,525 |
| Interest expense | \$ 8,670 | \$ | \$ 8,670 |
| Income tax recovery | \$ (93,000) | \$ (53,000) | \$ (146,000) |
| Segment loss | \$ (589,111) | \$ (391,997) | \$ (981,108) |
| Segment assets | \$2,892,447 | \$ 61,765 | \$2,954,212 |
| Capital expenditures | \$1,604,339 | \$ | \$1,604,339 |

Company's oil and gas production is further split into geographical segments: Canada and the United States of America ("US"). The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

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11. Segmented Information -- Continued

| Description – Dec 31, 2005 | Canada | US | Total |
|---------------------------------|--------------|------------|--------------|
| Petroleum and natural gas sales | \$ 2,261,836 | \$ 59,040 | \$ 2,320,876 |
| Oil & gas production assets | \$ 2,090,719 | \$ 238,988 | \$ 2,329,707 |
| License | \$ 51,471 | | \$ 51,471 |

| Description – Dec 31, 2004 | Canada | US | Total |
|---------------------------------|--------------|------------|--------------|
| Petroleum and natural gas sales | \$ 1,128,087 | \$ 88,405 | \$ 1,216,492 |
| Oil & gas production assets | \$ 1,850,214 | \$ 206,247 | \$ 2,056,461 |
| License | \$ 61,765 | \$ | \$ 61,765 |

12. Subsequent Events

In January 2006 the Company obtained a \$2,400,000 revolving credit facility through the National Bank of Canada to repay all credit facilities at Toscana Capital Corporation as outlined in Note 4, and provide working capital. The loan bears interest at the bank's prime rate plus (1%) percent per annum. The facility is secured against the assets of the corporation. Initial fees totaling \$4,000 were paid in relation to this financing.

On January 16, 2006 the Company granted incentive stock options to Management and Directors for a total of 1,250,000 common shares of the corporation at a price of \$0.25 per share for a period of five years, under the formal stock option plan approved at the Annual General Meeting held on September 15, 2005. The options are subject to a 4 month hold period expiring May 14, 2006.

13. Comparative Figures

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