

**AVNEL GOLD MINING LIMITED**

**CONSOLIDATED FINANCIAL STATEMENTS**

**DECEMBER 31, 2006**

# Management's Responsibility

## Management's Responsibility for Financial Statements

The accompanying consolidated financial statements have been prepared by and are the responsibility of the Board of Directors and Management of the Company.

The consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles and reflect Management's best estimates and judgements based on currently available information. The Company has developed and maintains a system of internal accounting controls in order to ensure, on a reasonable and cost effective basis, the reliability of its financial information.

The consolidated financial statements have been audited by Ernst & Young LLP. Their report outlines the scope of their examination and opinion on the consolidated financial statements.

"Roy Meade"  
Roy Meade  
Chief Executive Officer  
March 30, 2007

"Andrew Herbert"  
Andrew Herbert  
Chief Financial Officer  
March 30, 2007

## **REPORT OF INDEPENDENT AUDITORS**

We have audited the accompanying consolidated balance sheets of Avnel Gold Mining Limited as of December 31, 2006 and 2005, and the related consolidated statements of operations, cash flows and changes in stockholders' equity for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Avnel Gold Mining Limited for the year ended December 31, 2004, were audited by other auditors whose report dated March 18, 2005, (except for Note 9, dated March 29, 2005) expressed an unqualified opinion on those statements.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Avnel Gold Mining Limited at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP  
London  
30 March, 2007

Avnel Gold Mining Limited  
Consolidated Balance Sheets  
December 31, 2006 and 2005  
Expressed in thousands of US Dollars

|  | <u>Note</u> | <u>2006</u>      | <u>2005</u>      |
|--|-------------|------------------|------------------|
| <b>ASSETS</b>  |             |                  |                  |
| Cash and cash equivalents  |             | \$ 1,220         | \$ 5,420         |
| Inventories  | 4           | 2,516            | 2,118            |
| Prepaid and other assets   |             | 89               | 83               |
| Total current assets   |             | <u>3,825</u>     | <u>7,621</u>     |
| Property, plant and equipment, at cost                           | 5           |                  |                  |
| Mining properties and capitalized mine development costs         |             | 18,649           | 14,381           |
| Other property and equipment                                     |             | 6,736            | 6,277            |
|  |             | <u>25,385</u>    | <u>20,658</u>    |
| Accumulated depreciation   |             | 3,389            | 1,971            |
| Net property, plant and equipment                                |             | <u>21,996</u>    | <u>18,687</u>    |
| <b>Total Assets</b>  |             | <u>\$ 25,821</u> | <u>\$ 26,308</u> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                      |             |                  |                  |
| Accounts payable   | 6           | \$ 1,162         | \$ 1,042         |
| Tax creditor   | 14          | 744              | 277              |
| Other accrued liabilities  | 6           | 1,296            | 1,237            |
| Total current liabilities  |             | 3,202            | 2,556            |
| Notes payable - long term  | 7           | 11,821           | 11,821           |
| Retirement and rehabilitation obligations                        | 8           | 774              | 414              |
| <b>Total liabilities</b>   |             | <u>15,797</u>    | <u>14,791</u>    |
| Common stock:  |             |                  |                  |
| Authorised - unlimited number of ordinary shares of no par value |             |                  |                  |
| Issued and outstanding 56,123,528 (2005: 55,329,605)             | 9           | 21,457           | 20,728           |
| Additional paid in capital                                       |             | 4,491            | 4,041            |
| Retained deficit   |             | (15,928)         | (13,253)         |
| Accumulated other comprehensive income                           |             | 4                | 1                |
| <b>Total stockholders' equity</b>                                |             | <u>10,024</u>    | <u>11,517</u>    |
| <b>Total Liabilities and Stockholders' Equity</b>                |             | <u>\$ 25,821</u> | <u>\$ 26,308</u> |

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

“Howard B Miller”  
Howard B Miller  
Chairman

“Roy Meade”  
Roy Meade  
Chief Executive Officer

Avnel Gold Mining Limited  
**Consolidated Statement of Operations and Comprehensive Income**  
**For the Years Ended December 31, 2006, 2005 and 2004**  
**Expressed in thousands of US Dollars**  
**(except share and per share information)**

|  | <u>Notes</u> | <u>2006</u>       | <u>2005</u>       | <u>2004</u>       |
|--|--------------|-------------------|-------------------|-------------------|
| <b>REVENUE</b>                             |              |                   |                   |                   |
| Metal revenue                              |              | \$ 11,872         | \$ 5,699          | \$ 2,621          |
| <b>EXPENSES</b>                            |              |                   |                   |                   |
| Operating                                  |              | 9,448             | 6,633             | 5,144             |
| Depreciation                               |              | 1,416             | 1,108             | 834               |
| Exploration                                |              | 710               | 1,018             | 456               |
| Administration expense                     | 13           | 2,161             | 2,878             | 325               |
| <b>Total expenses</b>                      |              | <b>13,735</b>     | <b>11,637</b>     | <b>6,759</b>      |
| <b>Loss from operations</b>                |              | <b>(1,863)</b>    | <b>(5,938)</b>    | <b>(4,138)</b>    |
| <b>Other income (expense)</b>              |              |                   |                   |                   |
| Interest expense                           |              | (795)             | (1,357)           | (1,172)           |
| Exchange gain (loss)                       |              | (12)              | 193               | (97)              |
| <b>Total other expense</b>                 |              | <b>(807)</b>      | <b>(1,164)</b>    | <b>(1,269)</b>    |
| <b>Loss before income tax</b>              |              | <b>(2,670)</b>    | <b>(7,102)</b>    | <b>(5,407)</b>    |
| <b>Income tax expense</b>                  | 14           | <b>(5)</b>        | <b>(4)</b>        | <b>(4)</b>        |
| <b>Loss after income tax</b>               |              | <b>(2,675)</b>    | <b>(7,106)</b>    | <b>(5,411)</b>    |
| <b>Minority interest</b>                   |              | -                 | -                 | 337               |
| <b>Net loss</b>                            |              | <b>\$ (2,675)</b> | <b>\$ (7,106)</b> | <b>\$ (5,074)</b> |
| <b>Loss per share</b>                      |              | <b>\$(0.05)</b>   | <b>\$(0.29)</b>   | <b>\$(58.00)</b>  |
| <b>Weighted average shares outstanding</b> |              | <b>55,920,189</b> | <b>24,671,988</b> | <b>93,288</b>     |

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

**Avnel Gold Mining Limited**  
**Consolidated Statement of Cash Flows**  
**For the Years Ended December 31, 2006, 2005 and 2004**  
**Expressed in thousands of US Dollars**

|   | <u>2006</u>            | <u>2005</u>            | <u>2004</u>          |
|---|------------------------|------------------------|----------------------|
| <b>Cash flows from operating activities:</b>                      |                        |                        |                      |
| Net loss from continuing operations                               | \$ (2,675)             | \$ (7,106)             | \$ (5,411)           |
| Reconciled to net cash (used in) provided by operating activities |                        |                        |                      |
| Depreciation  | 1,418                  | 1,108                  | 834                  |
| Accretion and reclamation liability                               | 35                     | 32                     | -                    |
| Stock based compensation  | 450                    | 1,126                  | -                    |
| Change in tax creditor  | 467                    | 277                    | -                    |
| Changes in operating assets and liabilities                       |                        |                        |                      |
| Inventories   | (395)                  | (1,108)                | (996)                |
| Prepaid and other assets  | (6)                    | (6)                    | 103                  |
| Accounts payable  | 120                    | (527)                  | 306                  |
| Other accrued liabilities   | 787                    | 1,008                  | 1,185                |
| Net cash (used in) provided by operating activities               | <u>201</u>             | <u>(5,196)</u>         | <u>(3,979)</u>       |
| <b>Cash flows from investing activities:</b>                      |                        |                        |                      |
| Purchases and development of                                      |                        |                        |                      |
| Property, plant and equipment                                     | <u>(4,402)</u>         | <u>(2,735)</u>         | <u>(2,911)</u>       |
| Net cash used in investing activities                             | <u>(4,402)</u>         | <u>(2,735)</u>         | <u>(2,911)</u>       |
| <b>Cash flows from financing activities:</b>                      |                        |                        |                      |
| Issue of share capital  | 1                      | 12,102                 | 50                   |
| Advances from stockholders  | -                      | -                      | -                    |
| Proceeds from notes payable issued                                | -                      | 2,880                  | 7,001                |
| Repayment of notes payable  | -                      | (2,000)                | -                    |
| Minority interest   | -                      | -                      | -                    |
| Net cash provided by financing activities                         | <u>1</u>               | <u>12,982</u>          | <u>7,051</u>         |
| <b>Net increase in cash and cash equivalents</b>                  | <b>(4,200)</b>         | <b>5,051</b>           | <b>161</b>           |
| <b>Cash and cash equivalents at beginning of period</b>           | <b>5,420</b>           | <b>369</b>             | <b>208</b>           |
| <b>Cash and cash equivalents at end of period</b>                 | <u><u>\$ 1,220</u></u> | <u><u>\$ 5,420</u></u> | <u><u>\$ 369</u></u> |

**Supplemental disclosures of cash flow information**

The Company paid interest of \$70,000, \$117,000 and \$7,000 for the periods respectively. The Company paid income taxes of \$4,000, \$14,000 and \$0 for the periods respectively.

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

**Avnel Gold Mining Limited**

**Consolidated Statement of Changes in Stockholders' Equity**

**Expressed in thousands of US Dollars (except share information)**

|  | <u>Common Stock</u> |               | <u>Additional</u> | <u>Minority</u> | <u>Accumulated</u> | <u>Accumulated</u> | <u>Total</u>         |
|--|---------------------|---------------|-------------------|-----------------|--------------------|--------------------|----------------------|
|  | <u>Shares</u>       | <u>Amount</u> | <u>Paid in</u>    | <u>Interest</u> | <u>Deficit</u>     | <u>Other</u>       | <u>Stockholders'</u> |
|  |                     |               | <u>Capital</u>    |                 |                    | <u>Income</u>      | <u>Deficit</u>       |
| At December 31, 2003   | 50,000              | 50            | -                 | 337             | (573)              | 4                  | (182)                |
| Issuance of common stock   | 50,000              | 50            | -                 | -               | -                  | -                  | 50                   |
| Minority interest in the<br>loss of consolidated<br>subsidiary         | -                   | -             | -                 | (337)           | -                  | -                  | (337)                |
| Net loss   | -                   | -             | -                 | -               | (5,074)            | -                  | (5,074)              |
| Other comprehensive gain   | -                   | -             | -                 | -               | -                  | -                  | -                    |
| Exchange gain  | -                   | -             | -                 | -               | -                  | 5                  | 5                    |
| Comprehensive loss   | -                   | -             | -                 | -               | -                  | -                  | (5,069)              |
| At December 31, 2004   | 100,000             | 100           | -                 | -               | (5,647)            | 9                  | (5,538)              |
| Issuance of common stock<br>upon purchase of Avnel<br>Gold, Limited    | 200,000             | 100           | -                 | -               | -                  | -                  | 100                  |
| Elimination upon<br>Consolidation of Avnel<br>Gold, Limited            | (100,000)           | (100)         | -                 | -               | -                  | -                  | (100)                |
| Issuance of common stock<br>for cash, net of issue costs               | 20,329,605          | 9,942         | 2,160             | -               | -                  | -                  | 12,102               |
| Issuance of common stock<br>upon conversion of<br>shareholder loans    | 34,800,000          | 10,941        | -                 | -               | -                  | -                  | 10,941               |
| Issuance of warrants to<br>Agents, Brokers and<br>Minority Shareholder | -                   | (255)         | 755               | -               | (500)              | -                  | -                    |
| Stock based compensation   | -                   | -             | 1,126             | -               | -                  | -                  | 1,126                |
| Net loss   | -                   | -             | -                 | -               | (7,106)            | -                  | (7,106)              |
| Other comprehensive loss   | -                   | -             | -                 | -               | -                  | -                  | -                    |
| Exchange loss  | -                   | -             | -                 | -               | -                  | (8)                | (8)                  |
| Comprehensive loss   | -                   | -             | -                 | -               | -                  | -                  | (7,114)              |
| At December 31, 2005   | 55,329,605          | 20,728        | 4,041             | -               | (13,253)           | 1                  | 11,517               |
| Issuance of common stock<br>in payment of interest                     | 792,923             | 688           | -                 | -               | -                  | -                  | 688                  |
| Exercise of stock options  | 1,000               | 1             | -                 | -               | -                  | -                  | 1                    |
| Stock based compensation   | -                   | -             | 450               | -               | -                  | -                  | 450                  |
| Issue costs  | -                   | 40            | -                 | -               | -                  | -                  | 40                   |
| Net loss   | -                   | -             | -                 | -               | (2,675)            | -                  | (2,675)              |
| Other comprehensive loss   | -                   | -             | -                 | -               | -                  | -                  | -                    |
| Exchange loss  | -                   | -             | -                 | -               | -                  | 3                  | 3                    |
| Comprehensive loss   | -                   | -             | -                 | -               | -                  | -                  | (2,672)              |
| At December 31, 2006   | 56,123,528          | \$ 21,457     | \$ 4,491          | \$ -            | \$ (15,928)        | \$ 4               | \$ 10,024            |

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

**Avnel Gold Mining Limited**  
**Notes to the Consolidated Financial Statements**  
**Year ended December 31, 2006**  
Tabular amounts expressed in thousands of US Dollars

**1. Nature of Operations and Liquidity**

Avnel Gold Mining Limited (the "Company") was incorporated under the laws of Guernsey on February 18, 2005. On February 22, 2005, Elliott Associates L.P., Elliott International L.P. (collectively "Elliott") and Fern Trust ("Fern") acquired 100% of the issued and outstanding common shares of the Company in exchange for 95% of the issued and outstanding shares of Avnel Gold, Limited ("Avnel Cayman"), a company incorporated in the Cayman Islands, pursuant to a reorganization agreement. Under the reorganization agreement, obligations of Avnel Cayman to Elliott and Fern in respect of existing shareholder loans of Avnel Cayman were assumed by the Company. The reorganization has been accounted for as an exchange between entities under common control whereby the assets and liabilities of the Avnel Cayman group are initially recognized at their carrying amounts in the accounts of the Avnel Gold Mining Limited group at the date of the transfer. The results and cash flows for the year ended December 31, 2005 comprise the results and cash flows of the Company and the Avnel Cayman group as if they had been combined throughout the year. The results and cash flows for the year ended December 31, 2004 are the amounts reported by Avnel Cayman in its consolidated financial statements for the year ended December 31, 2004.

The Company, Elliott and Fern also entered into a transfer agreement and call option agreement with the minority shareholder of Avnel Cayman. Pursuant to the transfer agreement, the Company (i) purchased from the minority shareholder the remaining 5% (5,000 shares) of ordinary shares of Avnel Cayman outstanding for \$5,000, this amount was paid for by Elliott on behalf of the Company, (ii) granted to the minority shareholder a call option on the shares of the Company as described in a call option agreement (the "Call Option Agreement") and (iii) furthermore agreed to purchase all the rights and obligations with respect to loans of \$725,000 owed by Avnel Cayman to the minority shareholder for a consideration of \$725,000. At the date of the transfer agreement, the \$725,000 consideration was paid jointly by Fern and Elliott at which point the Company agreed to re-pay Elliott and Fern under the original terms of the loan. Under the Call Option Agreement, the minority shareholder has the right to purchase (i) 1,050,000 common shares of the Company at an exercise price of \$0.275 at any time before 5p.m. on December 31, 2009 and (ii) 435,400 common shares of the company at Cdn\$0.95 at any time before 5p.m. on December 31, 2009.

Avnel Cayman was incorporated in the Cayman Islands on September 28, 2001. On February 14, 2003 it entered into a Foundation Agreement with the Government of Mali for the development of the existing gold mining property at Kalana. Under the terms of the Foundation Agreement, a subsidiary company, SOMIKA, was established in Mali to develop the mining property. Eighty per cent of the voting equity is held by Avnel Cayman and 20 per cent is held beneficially by the Government of Mali. Avnel Cayman agreed to invest \$2,500,000 in the project, of which \$1,600,000 was invested on inception, \$300,000 was paid in 2004 and \$600,000 was paid in 2005. Additionally, Avnel Cayman agreed to spend \$1,375,000 on exploration and development over the first three years of the project all of which had been spent as of December 31, 2005.

Avnel Mali SARL ("Avnel Mali") was incorporated in Mali in 2003 and is a 100% owned subsidiary of Avnel Gold, Limited. During 2006, Avnel Mali acquired 100% of the interest in the Fougadian Exploration Permit, an area of 150 square kilometres which lies to the south of the Kalana Permit. If an exploitation company is formed, then the Government of the Republic of Mali is entitled to a 10% interest and Avnel Mali will hold the remaining 90% interest. In the first year after the award of the permit, Avnel Mali is required to spend a total of CFA 158,000,000 on the permit which is equivalent to \$318,000 at the year end exchange rate. As at December 31, 2006, Avnel Mali had spent \$131,000 on Fougadian Exploration Permit. The exploration permit is valid for a period of three years, renewable twice with 50% surface area reduction at each renewal.

Gold production commenced in January 2004 and the principal markets are European based bullion trading concerns.

**Avnel Gold Mining Limited**  
**Notes to the Consolidated Financial Statements**  
**Year ended December 31, 2006**  
Tabular amounts expressed in thousands of US Dollars

The Company's cash flow and profitability is dependent primarily on the volume of production, gold prices, operating costs, interest rates on borrowings and investments and discretionary expenditure levels including exploration, resource development and general and administrative costs. Since the Company has subsidiaries operating in UK, Mali and the Cayman Islands, exposure also arises from fluctuations in currency exchange rates, political risks and varying levels of taxation. While the Company seeks to manage these risks, many of these factors are beyond its control.

The U.S. Dollar is the functional currency of the Company's principal operations.

The consolidated financial statements have been presented on the basis that the Company is a going concern. Accordingly, the financial statements do not include adjustments relating to the carrying value of assets, the amounts and classification of liabilities, or other adjustments that might result should the Company be unable to continue as a going concern.

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (U.S. GAAP) which differs in certain respects from accounting principles generally accepted in Canada (Canadian GAAP), as described in Note 15 to these consolidated financial statements.

## **2. Management Estimates and Assumptions**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

## **3. Summary of Significant Accounting Policies**

### **Basis of Presentation**

The consolidated financial statements of the Company include the accounts of Avnel Gold Mining Limited and its subsidiaries Avnel Gold, Limited (Cayman Islands, 100%), Kalana Mine Services Limited (United Kingdom, 100 %), SOMIKA (Mali, 80 %) and Avnel Mali SARL (Mali, 100%). All intercompany balances and transactions have been eliminated in the consolidated financial statements.

### **Cash and Cash Equivalents**

Cash and cash equivalents include highly liquid investments with remaining maturities of three months or less at the date of purchase and which are not subject to significant risk from changes in interest rates.

### **Inventories**

Processed ores are stated at the lower of average cost or market. No account is taken of work in progress. Materials and supplies are stated at cost on a first in first out (FIFO) basis.

### **Property, Plant and Equipment**

All costs, other than acquisition costs, are expensed prior to the establishment of proven and probable reserves. Gains or losses resulting from the sale or abandonment of properties are included in operations. Acquisition and development costs associated with properties brought into production are charged to operations using the units-of-production method based on estimated proven and probable reserves which can be recovered. Acquisition costs were incurred in relation to the purchase of the assets of the gold mining property at Kalana. Development costs represent costs in relation to improving and extending mine infrastructure to access ore bodies at the Kalana mine. Costs of start-up activities and on-going costs to maintain production are expensed as incurred. Fixed asset costs include

**Avnel Gold Mining Limited**  
**Notes to the Consolidated Financial Statements**  
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production facilities and equipment, vehicles and office equipment. Production facilities and equipment are stated at cost and are amortized over the estimated proven and probable reserves which can be recovered from the related property. The weighted average useful life of production facilities and equipment is eight years. Vehicles and office equipment are stated at cost and are depreciated using the straight-line method over estimated useful lives of three to five years. Maintenance and repairs are charged to expense as incurred. Gains or losses on dispositions are included in operations.

**Impairments**

The Company evaluates the carrying value of its properties and equipment when events or changes in circumstances warrant. With respect to properties with proven and probable reserves, an impairment loss is recognized when the estimated future cash flows (undiscounted and without interest) expected to result from the use of the asset are less than the carrying amount of the asset. Measurement of the impairment loss is based on discounted cash flows. Properties with unproven reserves are assessed for impairment when changes in market conditions or events occur and are measured based on fair value. The company has not recorded any impairment losses in any of the periods. The company's estimates of future cash flows are subject to risks and uncertainties. It is reasonably possible that changes in estimates could occur which may affect the expected recoverability of investments in mining properties. Mining property impairment analyses were performed using a long term gold price of \$620 per oz for 2007 and 2008 and \$500 per oz for the years thereafter (2005: \$500 per oz) for gold sold at spot and the contracted price for gold that the company has committed to sell forward.

**Site Reclamation**

The fair value of a retirement or rehabilitation obligation is recognised as an asset and a liability in the period when it is incurred. The liability is discounted and an accretion expense is recognised using the credit-adjusted risk free rate in effect when the liability is incurred. The retirement asset is included in mining properties and charged to operations using the units of production method based upon estimated proven and probable reserves which can be recovered.

**Revenue Recognition**

Revenue from the sale of gold is recognized upon delivery when title passes. Gains and losses on gold forward sales agreements are recognised in metal revenue on the delivery date identified at the contract inception. Gold forward sales agreements are exempt from the provisions of Statement of Financial Accounting Standard No. 133 "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) as normal course sales requiring settlement through physical delivery.

**Income Taxes**

The Company computes deferred income taxes under the asset and liability method prescribed by Statement of Financial Account Standards No. 109 "Accounting for Income Taxes" (SFAS 109). This method recognizes the tax consequences of temporary differences between the financial statement amounts and the tax bases of certain assets and liabilities by applying statutory rates in effect when the temporary differences are expected to reverse. The Company records a valuation allowance against any portion of those deferred income tax assets that management believes will, more likely than not, fail to be realised.

**Foreign Currency**

Transactions expressed in foreign currencies are translated into U.S. Dollars at the rate of exchange prevailing on the date of transaction. Monetary assets and liabilities expressed in foreign currencies are re-converted into U.S. Dollars at the rates of exchange prevailing on the balance sheet date.

The financial statements of overseas subsidiaries are remeasured into their functional currency. Mining properties and other non-current assets are remeasured at historical rates.

**Avnel Gold Mining Limited**  
**Notes to the Consolidated Financial Statements**  
**Year ended December 31, 2006**  
Tabular amounts expressed in thousands of US Dollars

Monetary assets and liabilities are remeasured at current rates, except depreciation and amortization, which are remeasured at historical rates. Revenue and expense transactions are remeasured at the average rate for the period. Remeasurement gains and losses are included in income.

The assets and liabilities of subsidiaries with functional currencies other than the U.S. Dollar are translated into U.S. Dollars at the closing rate. Revenue and expense transactions are translated at the weighted average rate for the period. Translation gains and losses are included in other comprehensive income.

**Foreign Operations Risk**

The Company's main operating subsidiary is incorporated under the laws of Mali, and its principal mining facilities are located in Mali. Accordingly, the Company is directly affected by political and economic conditions in Mali. There can be no assurance that the Government of Mali will be successful in its attempt to keep prices and exchange rates stable. Instability in Mali may have a material adverse effect on the Company.

**Interest**

Interest is capitalized during the development phase of a project. Interest capitalization commences with the first expenditure for a qualifying asset and ends when the asset is substantially complete and ready for its intended use (the date when production commences).

The amount of interest cost that may be capitalized for any accounting period may not exceed the actual interest cost that is incurred during the period. Interest capitalized amounted to nil in 2006, nil in 2005 and \$134,000 in 2004.

To determine the amount of interest to be capitalized for a particular accounting period, the average accumulated investment in a qualifying asset during that period is calculated. If a specific borrowing is made to acquire the qualifying asset, the interest rate incurred on that borrowing may be used to determine the amount of interest costs to be capitalized. That interest rate is applied to the average accumulated investment for the period to calculate the amount of capitalized interest cost on the qualifying asset. Capitalized interest cost on average accumulated investments in excess of the amount of the specific borrowing is calculated by use of the weighted average interest rate incurred on other borrowings outstanding during the period.

**Stock Based Compensation**

The Company accounts for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123R. Stock options awarded to employees are accounted for at estimated fair value, based on the binomial model, and any related expense is recognized over the requisite service period. Compensation charged amounted to \$450,000 in 2006 and \$1,126,000 in 2005. There has been no compensation charge recorded in prior periods.

**Loss per Common Share**

Loss per common share is based on the weighted average number of common shares outstanding during the period. The fully diluted loss per common share has not been disclosed as the inclusion of unexercised options or warrants would be anti-dilutive.

**Impact of Recently Issued Accounting Pronouncements**

Under the U.S. Securities and Exchange Commission Staff Accounting Bulletin 74 ("SAB 74"), the Company is required to disclose information related to new accounting standards that have not yet been adopted.

In June 2006, the FASB issued FIN No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance

**Avnel Gold Mining Limited**  
**Notes to the Consolidated Financial Statements**  
**Year ended December 31, 2006**  
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with FASB Statement No. 109, Accounting for Income Taxes. The interpretation prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The provisions of FIN No. 48 are effective for fiscal years beginning after December 15, 2006 so will be applicable to Avnel from January 1, 2007. Avnel does not expect the adoption of FIN No. 48 to have a material impact on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This standard defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America, and expands disclosure about fair value measurements. SFAS No. 157 applies under other accounting standards that require or permit fair value measurements. Accordingly, this statement does not require any new fair value measurement. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 so will be applicable to Avnel from January 1, 2008. The Company is currently evaluating the requirements of SFAS No. 157 and has not yet determined the impact on our consolidated financial statements.

**Comparative Figures**

Certain comparatives have been reclassified to conform with the current year presentation.

**4. Inventories**

|                        | <u>2006</u>     |           | <u>2005</u>  |
|------------------------|-----------------|-----------|--------------|
| Metal inventory        | \$ 853          | \$        | 1,024        |
| Materials and supplies | 1,663           |           | 1,094        |
|                        | <u>\$ 2,516</u> | <u>\$</u> | <u>2,118</u> |

Metal inventory consists of 1,518 oz of gold held at Kalana mine site and 500 oz held to the credit of the company's gold bullion account in Switzerland. There were no material amounts of gold in work in progress or held in sand and ore stockpiles. The gold was valued at cost of \$423 per oz.

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**5. Property, Plant and Equipment**

|                                 | <u>Mine<br/>acquisition<br/>costs</u> | <u>Capitalized<br/>Development</u> | <u>Fixed Assets</u> | <u>Total</u>     |
|---------------------------------|---------------------------------------|------------------------------------|---------------------|------------------|
| <b>Cost</b>                     |                                       |                                    |                     |                  |
| Balance December 31, 2004       | \$ 3,374                              | \$ 8,143                           | \$ 6,406            | \$ 17,923        |
| Additions                       | 12                                    | 2,013                              | 710                 | 2,735            |
| Reclassification of assets      | -                                     | 839                                | (839)               | -                |
| Balance December 31, 2005       | 3,386                                 | 10,995                             | 6,277               | 20,658           |
| Additions                       | 50                                    | 4,218                              | 459                 | 4,727            |
| Balance December 31, 2006       | <u>\$ 3,436</u>                       | <u>\$ 15,213</u>                   | <u>\$ 6,736</u>     | <u>\$ 25,385</u> |
| <b>Accumulated Depreciation</b> |                                       |                                    |                     |                  |
| Balance December 31, 2004       | \$ 65                                 | \$ 174                             | \$ 626              | \$ 865           |
| Expense for year                | 108                                   | 334                                | 666                 | 1,108            |
| Translation adjustment          | -                                     | -                                  | (2)                 | (2)              |
| Balance December 31, 2005       | 173                                   | 508                                | 1,290               | 1,971            |
| Expense for year                | 172                                   | 504                                | 742                 | 1,418            |
| Balance December 31, 2006       | <u>\$ 345</u>                         | <u>\$ 1,012</u>                    | <u>\$ 2,032</u>     | <u>\$ 3,389</u>  |
| <b>Net Book Value</b>           |                                       |                                    |                     |                  |
| December 31, 2006               | <u>\$ 3,091</u>                       | <u>\$ 14,201</u>                   | <u>\$ 4,704</u>     | <u>\$ 21,996</u> |
| December 31, 2005               | <u>\$ 3,213</u>                       | <u>\$ 10,487</u>                   | <u>\$ 4,987</u>     | <u>\$ 18,687</u> |

All property, plant and equipment of the Company relates to the Kalana Mine in Mali except for corporate fixed assets which have a net book value of \$32,000 at December 31, 2006 (2005 - \$28,000).

**6. Accounts Payable and Accrued Liabilities**

|                                     | <u>2006</u>     | <u>2005</u>     |
|-------------------------------------|-----------------|-----------------|
| Trade creditors                     | \$ 1,162        | \$ 1,042        |
| Tax creditor                        | 744             | 277             |
| Accrued expenses                    | 871             | 918             |
| Interest payable to related parties | 425             | 319             |
|                                     | <u>\$ 3,202</u> | <u>\$ 2,556</u> |

**7. Notes Payable – long term**

|                        | <u>2006</u>      | <u>2005</u>      |
|------------------------|------------------|------------------|
| Convertible loan notes | \$ 10,941        | \$ 10,941        |
| Term loan              | 880              | 880              |
|                        | <u>\$ 11,821</u> | <u>\$ 11,821</u> |

The long term debt of the Company consists entirely of shareholder loans provided by Elliott and Fern, the major shareholders of Avnel (the "Shareholder Loans"). At June 30, 2005 an aggregate principal amount of \$19,255,000 of the Shareholder Loans, together with accrued interest thereon in the amount of \$2,627,000, was converted into equal amounts of common shares (see Note 9) and convertible loan notes with an aggregate principal amount of \$10,941,000.

Each convertible loan note is convertible by the holder into common shares of the Company at Cdn\$0.95 per share at any time prior to the close of business of the Company on the fifth business day prior to June 30, 2010. The number of shares issuable on conversion is equal to

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the principal amount to be converted divided by the U.S. Dollar equivalent of Cdn\$0.95. The U.S Dollar equivalent is derived by reference to the Bank of Canada noon rate on the date of conversion. The total number of common shares that could be issued if all the loan notes are converted is dependant on the U.S. Dollar to Canadian Dollar exchange rate. Using the Bank of Canada noon rate as of December 31, 2006, this would equate to 13,433,235 common shares.

The convertible loan notes bear interest at the six month U.S. LIBOR plus 2% payable bi-annually. The Company may elect to pay the interest in common shares in lieu of cash. The numbers of shares payable in lieu of interest is calculated by dividing the cash value of the interest payable by the U.S. Dollar equivalent of the 20-day weighted average trading price of the common shares with the last day being five trading days before the interest payment date. During 2006, the Company issued 792,923 common shares of the Company in settlement of accrued interest of \$687,505. Subsequent to the end of the year the Company issued 542,659 common shares of the Company in settlement of the \$429,016 interest accrued.

Upon maturity, the company may elect to repay the outstanding principal amount in common shares at Cdn\$0.95 per share if the 40-day weighted average trading price of the common shares prior to the conversion date is equal to the Canadian Dollar equivalent of \$1.20. The term of the convertible loan notes is five years with a maturity date of June 30, 2010.

Bridge financing loans payable to shareholders as at June 30, 2005 of \$2,800,000, together with interest accrued thereon in the amount of \$80,000 were converted into term loans due December 31, 2008, bearing interest at a rate of 8% per annum. On December 31, 2005 the Company repaid \$2,000,000 of this amount together with accrued interest thereon in the amount of \$116,572. During 2006, the Company paid an amount of \$70,374 in settlement of the interest on term loans.

**8. Retirement and rehabilitation obligations**

During 2004, the Company estimated a fair value for retirement and rehabilitation obligations of \$382,000 based on management's experience of similar sites. During 2006, the Company commissioned an environmental report by an independent party. This estimated an increase in estimated cash flow for the retirement and rehabilitation of Kalana Mine from \$1,000,000 to \$2,236,000. The increase in fair value was estimated at \$325,000. The environmental liability is based on the work required to be carried out on the tailings facilities to ensure stabilisation of the facility and re-vegetation of the tailings surface area, the capping of the underground shafts and the reclamation of plant, workshops and buildings where appropriate. The area disturbed by mining operations will then be re-vegetated. There will then be an ongoing monitoring of the water quality and re-vegetation programmes.

The Company has used a credit-adjusted risk-free rate of 8.5% to discount future cash flows in arriving at the fair value of its asset retirement and rehabilitation obligations. This is also the rate at which shareholders advanced funds to the Company in 2004.

A reconciliation of the asset retirement obligation carrying amounts is shown below:

|  |                   |
|--|-------------------|
| <b>Asset retirement obligation as at December 31, 2004</b> | <b>\$ 382,000</b> |
| Accretion expenses recorded in 2005                        | 32,000            |
| <b>Asset retirement obligation as at December 31, 2005</b> | <b>\$ 414,000</b> |
| Accretion expenses recorded in 2006                        | 35,000            |
| Increase in fair value of asset retirement obligation      | 325,000           |
| <b>Asset retirement obligation as at December 31, 2006</b> | <b>\$ 774,000</b> |

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**9. Share Capital**

Avnel's authorized share capital consists of an unlimited number of common shares of no par value. The total number of common shares issued is shown in the Statement of Changes of Stockholders' Equity.

On June 30, 2005, the Company completed its initial public offering with the issue of 12,393,605 units (the "Units") of the Company at a price of Cdn\$0.76 per Unit. Each Unit consists of one common share (the "Common Shares") of Avnel and one-half of one Common Share purchase warrant, each whole Common Share purchase warrant entitling the holder to purchase one Common Share (the "Warrant Shares") at a price of Cdn\$1.06 per Warrant Share at any time before 5p.m. on June 30, 2010. The Company granted the Agents of the IPO a non-transferable option to purchase 279,666 Units at the offer price up to June 30, 2007. Should units be purchased, then the resultant warrants are convertible in to Common Shares at an exercise price of Cdn\$1.06 any time before 5p.m. on June 30, 2010.

As discussed in Note 7 above, Shareholder Loans together with accrued interest thereon in the total amount of \$10,941,000 was converted into 34,800,000 common shares on June 30, 2005.

On November 29, 2005 the Company completed a private placement of 7,936,000 units at Cdn\$1.00 per unit, each unit comprising one common share and one common share purchase warrant, exercisable for two years at Cdn\$1.30 per share. The Company granted the Agents of the private placement offering a non-transferable option to purchase 558,600 units at the offer price up to May 29, 2007. Should units be purchased, then the resultant common share purchase warrants are convertible in to common shares at an exercise price of Cdn\$1.30 any time before 5p.m. on November 29, 2007.

The details of the common shares issued and outstanding are as follows:

|   |                   |
|---|-------------------|
| <b>Common shares issued and outstanding as at December 31, 2005</b> | <b>55,329,605</b> |
| Issued in lieu of interest due on convertible loan notes            | 792,923           |
| Stock options exercised   | 1,000             |
| <b>Common shares issued and outstanding as at December 31, 2006</b> | <b>56,123,528</b> |

A summary of options or rights to purchase common shares of Avnel is shown in the following table.

|   |                   |
|---|-------------------|
| <b>Options or rights to purchase common shares as at December 31, 2004</b>              | <b>Nil</b>        |
| Warrants issued through the IPO on June 30, 2005 (1)                                    | 6,196,801         |
| Warrants issued through the Private Placement on November 29, 2005 (1)                  | 7,936,000         |
| Agents' warrants related to the IPO (1)(5)  | 419,499           |
| Broker's warrants related to the private placement (1)(6)                               | 1,117,200         |
| Convertible Loan Notes (2)  | 13,427,476        |
| Minority shareholder warrants (3)   | 1,485,400         |
| CEO Compensation Options (4)  | 2,500,000         |
| Stock Option Plan (4)   | 1,850,000         |
| <b>Options or rights to purchase common shares as at December 31, 2005</b>              | <b>34,932,376</b> |
| Stock options exercised   | (1,000)           |
| Stock options forfeited   | (250,000)         |
| Convertible loan notes – difference in exchange rates in the conversion calculation (2) | 5,759             |
| <b>Options or rights to purchase common shares as at December 31, 2006</b>              | <b>34,687,135</b> |

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Notes to the table

1. As at December 31, 2006, no warrants had been exercised
2. See note 7 to the financial statements
3. See note 1 to the financial statements of the company pursuant to which Avnel granted to the minority shareholder two warrants providing, respectively, a right to acquire (i) 1,050,000 common shares at \$0.275 and (ii) a right to acquire 435,400 common shares at Cdn\$0.95
4. See note 13 to the financial statements
5. Comprises 279,666 units, each unit being a warrant to purchase one common share and one half of one common share purchase warrant
6. Comprises 558,600 units, each unit being a warrant to purchase one common share and one common share purchase warrant

**10. Commitments and Contingencies**

The Company has entered into operating leases for office space and equipment with a company related to Fern. Pursuant to these leases which expire in June 2008, future minimum payments will amount to £65,500 per annum, which at the 2006 year end exchange rate, is equivalent to \$128,000 per annum.

The Company has entered into an operating lease for an office building in Bamako, Mali. The lease expires in March 2007. The remaining commitment at December 31, 2006 is \$3,000.

The Company has a commitment to purchase laboratory equipment used in relation to exploration and development from SGS Analabs in Mali. The remaining commitment as at December 31, 2006 amounts to \$16,000.

The Company has a commitment to spend a total of CFA 158,000,000 on its Fougadian Exploration Permit which is equivalent to \$318,000 at the year end exchange rate. As at December 31, 2006, Avnel Mali had spent \$131,000.

**11. Financial Instruments**

The Company does not acquire, hold or issue financial instruments for trading purposes. The estimated fair values of the Company's financial instruments approximate carrying values at December 31, 2006. The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

Cash and cash equivalents - carrying amounts approximate fair value based on the short term maturity of those instruments.

Long term debt - carrying amounts approximate fair value as the debt bears interest at market rates.

As at December 31, 2006, the Company had sold forward 6,860 ounces of gold at an average price of \$441 per ounce. The Company believes that these forward sales qualify as normal sales contracts under SFAS 133 and will record the revenues when the gold sold forward is delivered. These forward sales agreements were entered into with Elliott, one of the shareholders of the Company.

At December 31, 2006, based on the spot price of \$632 per oz, the mark-to-market value of the company's gold forward sales agreements was negative \$1,381,000 (2005: negative \$1,990,000). All gold sold forward is for delivery in 2007.

The credit risk in relation to financial instruments is the risk that a third party might fail to fulfil its performance obligations under the terms of a financial instrument. For cash and cash equivalents, credit risk represents the carrying amount on the balance sheet. The Company holds the majority of its cash and cash equivalents at large, reputable financial institutions. For forward sales, when the mark-to-market value is positive, this creates credit risk. When the mark-to-market value of a forward sale is negative, there is no credit risk. A

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table showing the concentration of credit risk as at December 31, 2006 is shown in the following table.

|                           | <u>United</u><br><u>Kingdom</u> |    | <u>Mali</u> |    | <u>Total</u> |
|---------------------------|---------------------------------|----|-------------|----|--------------|
| Cash and cash equivalents | \$ 1,178                        | \$ | 42          | \$ | 1,220        |
| Number of counterparties  | 1                               |    | 1           |    | 2            |

**12. Related Party Transactions**

As described in note 10, the Company has entered into operating leases for office space and equipment with Fern. Rent expense amounted to \$109,000 (2005: \$108,000; 2004: \$93,000) and the amount outstanding at December 31, 2006 was nil (2005: nil). The rental payments are denominated in Sterling so the U.S. Dollar amount payable is subject to fluctuation with the movement in exchange rates between Sterling and the U.S. Dollar.

As described in note 11, the company has entered into forward sales agreements with a shareholder. Metal revenue includes \$5,286,000 from forward sales agreements (2005: \$2,919,000; 2004: \$2,102,000) and the amount outstanding at December 31, 2006 was nil (2005:nil; 2004: nil). As at December 31, 2006 the planned forward sales for 2007 were 6,860 ounces which would generate revenue of \$3,029,000.

SOMIKA purchased \$276,000 of explosives during 2006 from African Explosives Limited ("AEL"). Mr. Ibrahim Kantao, a director of Avnel and SOMIKA, is also the Director-General of AEL Mali.

The Company received bridge financing loans as described in Note 7.

The funding of SOMIKA has principally been through advances by Fern, Elliott and the minority shareholder of Avnel Cayman. In July 2003, a separate entity, Caynton, advanced funds to SOMIKA at commercial interest rates. Avnel Cayman then assigned to Caynton, \$3.5 million of its outstanding loans with SOMIKA. The shareholders subsequently advanced further loans to SOMIKA through Caynton. The entire Caynton Loan of \$17.92 million, including accrued interest, was assigned to Avnel Cayman on December 31, 2004. The subsequent shareholder Bridge Financing Loans have been made to Avnel Cayman. All outstanding loans have subsequently been assigned to Avnel on February 23, 2005.

**13. Employee Stock Based Compensation**

**(i) The Stock Option Plan**

On February 23, 2005, the board of directors of Avnel adopted the Company's Stock Option Plan (the "Plan") effective upon the completion of the IPO Offering of June 30, 2005. The Plan was adopted by the board of directors in order to have a stock option plan which complies with the rules and policies of the Toronto Stock Exchange in place upon completion of the IPO Offering. Under the terms of the Plan, options can be granted to directors, employees or consultants of the Company. Two consultants of the Company have been granted options. Other than the vesting date which can be determined by the Board of the Company as it sees appropriate, the terms and conditions applicable to the consultants' options are the same as for directors and employees. The maximum number of Common Shares reserved for issuance under the Plan is 5,612,353. Options granted under the Plan are subject to the following terms and conditions:

- (a) the maximum number of common shares which may be reserved for issuance under the Plan, together with any other compensation arrangement of the Company, to insiders shall not exceed 5% of the outstanding common shares, and to any one insider and such insider's associates in any 12 month period shall not exceed 5% of the outstanding common shares. Under the Plan the maximum

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number of common shares reserved for issuance to any one person shall be 5% of the outstanding common shares at the date of issuance.

- (b) The exercise price of an option shall not be lower than the closing price of the common shares on the TSX on the day immediately preceding the day of grant of such option.
- (c) The Board of the Company shall determine the time during which any options may vest and the method of vesting or that no vesting restriction shall exist.
- (d) Options shall have a maximum term of ten years from the date of the grant, subject to any limits of any law or other regulatory body having jurisdiction.
- (e) Unless otherwise determined by the Board of the Company, an option will terminate 90 days after an optionee ceases to be an eligible participant (i.e. upon ceasing to be a director, officer or consultant of the Company).
- (f) In the event of the death of an eligible participant, the option will be exercisable, unless by its terms it sooner terminates or expires, within 90 days following such death by the persons to whom the eligible participant's rights, under the Plan, pass by will or the laws of descent and distribution, and
- (g) Options are non-transferable without the consent of the Company's Board.

Generally, other than options that vest on the grant date, the period from grant date to vesting is between one and three years.

**(ii) The CEO Compensation Option**

On February 23, 2005, Avnel granted to Roy Meade, Chief Executive Officer of Avnel, an option (the "CEO Compensation Option") to acquire up to 2.5 million common shares of Avnel at an exercise price per share of the Canadian Dollar equivalent of US\$0.275. One third of the option was exercisable on June 30, 2005, one-third on February 23, 2006, and the remaining one-third was exercisable on February 23, 2007. The maximum number of options that can be issued under the CEO Compensation Option is 2.5 million. As at December 31, 2006, none of these options had been exercised. Mr. Meade's entitlement to any unexercised portion of the CEO Compensation Option will terminate in the event he leaves employment of Avnel at his own volition prior to the exercise date. The CEO Compensation Options do not form part of Avnel's Stock Option Plan.

At the time of the Company's reorganization referred to in Note 1, the CEO Compensation Option was granted to replace the existing arrangement between Mr Meade and Avnel Cayman in September 2003 under which no compensation was recorded as performance conditions were not met.

**(iii) Summary of Options Granted**

The fair value of the options for both the stock option plan and the CEO Compensation Option has been estimated using the Binomial option model with the following assumptions:

|                         |             |
|-------------------------|-------------|
| Risk-free interest rate | 3.9% - 4.1% |
| Expected option term    | 10 years    |
| Expected volatility     | 40%         |
| Expected dividend yield | Nil%        |

The maximum expected option term of ten years has been used as Avnel does not have any previous history of issuing options and has no reason to conclude that a shorter term is more appropriate. The interest rate assumptions used are available by reference to Canadian market data. Credifinance, the Company's advisors for the initial public offering, estimated

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the volatility of Avnel by reference to their proprietary databases of similar companies as being 40%. This figure was accepted by Avnel, and is still believed to be the best estimate for volatility in the absence of adequate trading data or a suitable reference index.

Using these assumptions the total value of the options granted amounts to \$1,840,000. For the year ended December 31, 2006 administration expense includes compensation expense of \$450,000 (2005- \$1,126,000) and the corresponding amount has been credited to Additional Paid in Capital. In addition a further \$264,000 of stock option expense is expected to be amortized over a weighted average period of 2.4 years.

The table below summarizes the options granted and outstanding at December 31, 2006.

|                                  | <u>Shares</u> | <u>Weighted<br/>average<br/>exercise<br/>price</u> | <u>Weighted<br/>average<br/>remaining<br/>contractual<br/>term</u> | <u>Aggregate<br/>Intrinsic<br/>Value</u> |
|----------------------------------|---------------|--|--|--|
| <b>Stock Option Plan</b>         |               |  |  |  |
| Outstanding at December 31, 2004 | -             | -  | -  | -  |
| Granted                          | 1,850,000     | \$ 0.65  | -  | -  |
| Exercised                        | -             | -  | -  | -  |
| Forfeited                        | -             | -  | -  | -  |
| Expired                          | -             | -  | -  | -  |
| Outstanding at December 31, 2005 | 1,850,000     | \$ 0.65  | 9.7  | \$ 383                                   |
| Granted                          | -             | -  | -  | -  |
| Exercised                        | 1,000         | \$ 0.64  | -  | -  |
| Forfeited                        | 250,000       | \$ 0.64  | -  | -  |
| Expired                          | -             | -  | -  | -  |
| Outstanding at December 31, 2006 | 1,599,000     | \$ 0.65  | 8.7  | \$ 116                                   |
| Exercisable at December 31, 2006 | 699,000       | \$ 0.65  | 8.7  | \$ 54                                    |
| <b>CEO Compensation Option</b>   |               |  |  |  |
| Outstanding at December 31, 2004 | -             | -  | -  | -  |
| Granted                          | 2,500,000     | \$ 0.28  | -  | -  |
| Exercised                        | -             | -  | -  | -  |
| Forfeited                        | -             | -  | -  | -  |
| Expired                          | -             | -  | -  | -  |
| Outstanding at December 31, 2005 | 2,500,000     | \$ 0.28  | 9.1  | \$ 1,478                                 |
| Granted                          | -             | -  | -  | -  |
| Exercised                        | -             | -  | -  | -  |
| Forfeited                        | -             | -  | -  | -  |
| Expired                          | -             | -  | -  | -  |
| Outstanding at December 31, 2006 | 2,500,000     | \$ 0.28  | 8.1  | \$ 1,134                                 |
| Exercisable at December 31, 2006 | 1,666,666     | \$ 0.28  | 8.1  | \$ 756                                   |

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A summary of the status of the Company's nonvested share options as of December 31, 2006, and changes during the years ended December 31, 2006 and December 31, 2005 is presented below.

|                                | <u>Shares</u> | <u>Weighted<br/>average grant-<br/>date fair value</u> |
|--------------------------------|---------------|--|
| <b>Stock Option Plan</b>       |               |  |
| Nonvested at December 31, 2004 | -             | -  |
| Granted                        | 1,850,000     | \$ 0.54  |
| Vested                         | (550,000)     | \$ 0.53  |
| Forfeited                      | -             | -  |
| Nonvested at December 31, 2005 | 1,300,000     | \$ 0.54  |
| Granted                        | -             | -  |
| Vested                         | (200,000)     | \$ 0.55  |
| Forfeited                      | (200,000)     | 0.54   |
| Nonvested at December 31, 2006 | 900,000       | \$ 0.54  |
| <b>CEO Compensation Option</b> |               |  |
| Nonvested at December 31, 2004 | -             | -  |
| Granted                        | 2,500,000     | \$ 0.38  |
| Vested                         | (833,333)     | \$ 0.38  |
| Forfeited                      | -             | -  |
| Nonvested at December 31, 2005 | 1,666,667     | \$ 0.38  |
| Granted                        | -             | -  |
| Vested                         | (833,333)     | \$ 0.38  |
| Forfeited                      | -             | -  |
| Nonvested at December 31, 2006 | 833,334       | \$ 0.38  |

All vested shares that are outstanding are also exercisable.

Upon exercise of an option, the Company will issue new common shares. The Company's authorised capital consists of an unlimited number of common shares.

**14. Provision for taxes based on income**

The Company has income tax expense for the years ended December 31, 2006, 2005 and 2004 resulting from taxable income in companies which cannot be offset by losses incurred in other companies which operate in different tax jurisdictions.

The Company's statutory income tax rate for the years ended December 31, 2006, 2005 and 2004 is nil in the jurisdictions of Guernsey and the Cayman Islands in which the Company and Avnel Cayman are incorporated.

|   | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|-------------|
| Statutory tax rate applied to pre-tax loss representing |             |             |             |
| Income tax benefit of loss before tax                   | \$ Nil      | \$ Nil      | \$ Nil      |
| Reconciling item:                                       |             |             |             |
| Foreign tax charges                                     | 5           | 4           | 4           |
| Income tax expense                                      | <u>\$ 5</u> | <u>\$ 4</u> | <u>\$ 4</u> |

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The components of deferred income taxes, net as of December 31 2006, 2005 and 2004, are as follows (in thousands):

|   |             |             |             |
|---|-------------|-------------|-------------|
| Deferred tax liabilities:                   | <u>2006</u> | <u>2005</u> | <u>2004</u> |
| Property, plant and equipment               | 905         | 1,142       | (159)       |
| Net operating loss and credit carryforwards | (5,970)     | (4,497)     | (2,392)     |
|   | 5,065       | 3,355       | 2,551       |
| Valuation allowance                         | (5,065)     | (3,355)     | (2,551)     |
| Total deferred tax liabilities              | <u>Nil</u>  | <u>Nil</u>  | <u>Nil</u>  |

No other deferred tax assets and liabilities resulting from temporary differences in recognition of income and expenses for tax and financial reporting purposes existed at December 31, 2006, 2005 or 2004.

The provision for income taxes for the years ended December 31, 2006, 2005 and 2005 result in effective tax rates of (0.15)%, (0.06)% and (0.08)%, respectively.

**15. Canadian Generally Accepted Accounting Principles**

Canadian Generally Accepted Accounting Principles ("Canadian GAAP") vary in certain respects from U.S. GAAP. The effect of the principal measurement differences on the Company's consolidated financial statements are described below.

**Comprehensive Income (Loss)**

Under Canadian GAAP there is no requirement to disclose comprehensive income (loss).

**Convertible Loan Notes**

Under Canadian GAAP, the Company's convertible loan notes would be recorded in part as debt and in part as shareholders' equity, rather than entirely as debt as considered under U.S. GAAP. The amount recorded as debt represents the present value of future interest and principal amounts of the notes. The amount will be accreted to the face value of the notes over the term to maturity through periodic charges to interest expense.

Under Canadian GAAP, the convertible loan notes liability would originally decrease by \$916,000, and other paid in capital, included in shareholders' equity, would increase by \$916,000.

The following table presents the net loss and loss per share following Canadian GAAP:

|  |                  |                  |                   |
|--|------------------|------------------|-------------------|
|  | <u>2006</u>      | <u>2005</u>      | <u>2004</u>       |
| Net loss under US GAAP                 | \$ (2,675)       | \$ (7,106)       | \$ (5,074)        |
| Accretion of convertible notes         | (184)            | (91)             | Nil               |
| Net loss under Canadian GAAP           | (2,859)          | (7,197)          | (5,074)           |
| Net loss per share under Canadian GAAP | <u>\$ (0.05)</u> | <u>\$ (0.29)</u> | <u>\$ (58.00)</u> |

**16. Subsequent Events**

On February 7, 2007, the Company announced that it was issuing rights to subscribe for additional common shares to eligible shareholders. The Company issued to shareholders one right for every common share held. The shareholder was able to subscribe for one common share for every eight rights held for a purchase price of Cdn\$0.50 at any time prior to the expiration of rights at 4.00 pm March 15, 2007, Toronto time. The Company raised gross proceeds of Cdn\$3,541,635 and issued 7,083,270 common shares. Elliott entered into a stand-by agreement with the Company pursuant to which Elliott agreed to purchase, or arrange the

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purchase of all common shares issuable on the exercise of rights which were not acquired by other holders of rights.

The exercise price of the rights was at less than 90% of the market value of the shares. This has triggered the anti-dilutive provisions in the warrant and convertible loan note agreements leading to a change in exercise price and number of common shares issuable as shown in the tables below:

|  | <b>Exercise Price</b>         |                                |
|--|-------------------------------|--------------------------------|
|  | <b>Pre-rights issue Cdn\$</b> | <b>Post-rights issue Cdn\$</b> |
| Warrants issued through the IPO on June 30, 2005                   | 1.06                          | 1.008                          |
| Warrants issued through the Private Placement on November 29, 2005 | 1.30                          | 1.229                          |
| Agents' warrants related to the IPO                                | 0.76                          | 0.722                          |
| Broker's warrants related to the private placement                 | 1.00                          | 0.951                          |
| Convertible Loan Notes   | 0.95                          | 0.898                          |
| Minority shareholder warrants                                      | 0.275 (US\$)                  | 0.260 (US\$)                   |

|  | <b>Common Shares Issuable</b> |                          |
|--|-------------------------------|--------------------------|
|  | <b>Pre-rights issue</b>       | <b>Post-rights issue</b> |
| Warrants issued through the IPO on June 30, 2005                   | 6,196,801                     | 6,518,713                |
| Warrants issued through the Private Placement on November 29, 2005 | 7,936,000                     | 8,392,748                |
| Agents' warrants related to the IPO                                | 419,499                       | 441,291                  |
| Broker's warrants related to the private placement                 | 1,117,200                     | 1,175,236                |
| Minority shareholder warrants                                      | 1,485,400                     | 1,545,832                |

There is no change to the number of shares issuable on conversion of the convertible loan notes.