

FORTUNA SILVER MINES INC.

CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2007 AND DECEMBER 31, 2006
(Expressed in thousands of Canadian Dollars)



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AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Fortuna Silver Mines Inc. as at December 31, 2007 and 2006 and the consolidated statements of operations and comprehensive loss, shareholders' equity and cash flows for the year ended December 31, 2007 and the fifteen month period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2007 and 2006 and the results of its operations and its cash flows for the year ended December 31, 2007 and the fifteen month period ended December 31, 2006 in accordance with Canadian generally accepted accounting principles.

Chartered Accountants

Vancouver, Canada

March 20, 2008

FORTUNA SILVER MINES INC.
CONSOLIDATED BALANCE SHEETS
AS AT DECEMBER 31, 2007 AND 2006
(Expressed in thousands of Canadian Dollars)

	<u>December 31, 2007</u>	<u>December 31, 2006</u>
ASSETS		
CURRENT		
Cash and cash equivalents	\$ 47,240	\$ 1,641
Derivatives (Note 5)	1,400	-
Accounts receivable and prepaid expenses (Note 6)	2,051	1,901
GST and value added taxes	5,147	3,738
Inventories (Note 7)	1,693	826
	<u>57,531</u>	<u>8,106</u>
LONG-TERM INVESTMENTS (Note 8)	908	741
PROPERTY, PLANT & EQUIPMENT (Note 9)	13,669	7,806
MINERAL PROPERTIES (Note 10)	52,338	42,541
	<u>\$ 124,446</u>	<u>\$ 59,194</u>
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	\$ 5,917	\$ 2,193
Due to related parties, net (Note 11)	14	27
Current portion of obligation under capital lease (Note 12)	439	45
Loans (Note 12)	-	5,730
	<u>6,370</u>	<u>7,995</u>
OBLIGATIONS UNDER CAPITAL LEASE (Note 12)	433	97
ASSET RETIREMENT OBLIGATION (Note 13)	1,916	1,758
FUTURE INCOME TAX LIABILITY (Note 14)	8,069	4,910
NON-CONTROLLING INTEREST (Note 10)	6,593	3,227
	<u>23,381</u>	<u>17,987</u>
SHAREHOLDERS' EQUITY		
SHARE CAPITAL (Note 15)	100,159	43,341
CONTRIBUTED SURPLUS	11,770	6,085
DEFICIT	(11,008)	(8,219)
ACCUMULATED OTHER COMPREHENSIVE INCOME (Note 16)	144	-
	<u>101,065</u>	<u>41,207</u>
	<u>\$ 124,446</u>	<u>\$ 59,194</u>

Nature and continuance of operations (Note 1)

Commitments (Note 19)

Subsequent events (Note 20)

APPROVED BY THE DIRECTORS:

"signed", Director
Jorge Ganoza Durant

"signed", Director
Simon Ridgway

(See accompanying Notes)

FORTUNA SILVER MINES INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
FOR THE YEAR ENDED DECEMBER 31, 2007 AND FOR THE FIFTEEN MONTH PERIOD
ENDED DECEMBER 31, 2006
(Expressed in thousands of Canadian Dollars, except for share and per share amounts)

	Year ended December 31, 2007	15 month period ended December 31, 2006
Sales	\$ 31,667	\$ 3,372
Cost of sales (including depletion, depreciation and accretion of \$5,766 and \$919)	18,447	2,175
MINE OPERATING INCOME	13,220	1,197
Selling, general and administrative expenses (includes depreciation of \$32 and \$0)	6,127	2,025
Stock-based compensation (Note 15)	6,974	4,132
Write-off of deferred exploration costs	12	40
	13,113	6,197
OPERATING INCOME (LOSS)	107	(5,000)
Interest and other income and expenses	1,529	470
Interest and finance expenses	(90)	(23)
Net gain on commodity contracts (Note 5)	1,558	-
Loss on disposal of property, plant and equipment	(59)	-
Gain on disposal of investment	-	26
Foreign exchange (loss) gain	(1,665)	673
	1,273	1,146
INCOME (LOSS) BEFORE INCOME TAXES AND NON-CONTROLLING INTEREST	1,380	(3,854)
Income tax provision (Note 14)	4,261	494
Non-controlling interest	(92)	-
	(2,789)	(4,348)
NET LOSS FOR THE PERIOD	\$ (2,789)	\$ (4,348)
Other comprehensive loss, net of tax Unrealized loss on available for sale long-term investments (Note 8)	(305)	-
COMPREHENSIVE LOSS FOR THE PERIOD	(3,094)	(4,348)
Loss per share - Basic and diluted	\$ (0.04)	\$ (0.12)
Comprehensive loss per share - Basic and diluted	\$ (0.04)	\$ (0.12)
Weighted average number of shares outstanding	71,602,275	36,834,106

(See accompanying Notes)

FORTUNA SILVER MINES INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
FOR THE YEAR ENDED DECEMBER 31, 2007 AND FOR THE FIFTEEN MONTH PERIOD
ENDED DECEMBER 31, 2006
(Expressed in thousands of Canadian Dollars, except for share amounts)

	Share Capital		Share subscriptions and obligation to issue shares and warrants	Contributed surplus	(Deficit)	Total Shareholders' Equity
	Shares	Amount				
Balance – September 30, 2005	20,083,465	\$ 12,164	\$ 6,616	\$ 296	\$ (3,871)	\$ 15,205
Exercise of options	650,000	424	-	-	-	424
Exercise of warrants	6,124,631	5,601	-	-	-	5,601
Private placement for cash	16,700,000	22,050	(2,031)	-	-	20,019
Private placement commission non-cash transaction	760,261	1,140	-	-	-	1,140
Private placement acquisition non-cash transaction	1,897,621	2,714	(2,714)	-	-	-
Fair value of share purchase warrants issued	-	-	(1,871)	1,871	-	-
Property finders fee non-cash transaction	50,000	68	-	-	-	68
Property acquisition non-cash transaction	168,417	285	-	-	-	285
Loan fee	153,333	276	-	-	-	276
Transfer of contributed surplus on exercise of options	-	214	-	(214)	-	-
Stock based compensation	-	-	-	4,132	-	4,132
Issue costs (non-cash amount \$1,140)	-	(1,595)	-	-	-	(1,595)
(Loss) for the period	-	-	-	-	(4,348)	(4,348)
Balance December 31, 2006	46,587,728	\$ 43,341	\$ -	\$ 6,085	\$ (8,219)	\$ 41,207

	Share Capital		Contributed Surplus	(Deficit)	Accumulated Other Comprehensive Income	Total Shareholders' Equity
	Shares	Amount				
Balance – December 31, 2006	46,587,728	\$ 43,341	\$ 6,085	\$ (8,219)	\$ -	\$ 41,207
Cumulative impact of accounting changes, net of tax (Note 4)	-	-	-	-	449	449
Exercise of options	1,753,600	1,957	-	-	-	1,957
Exercise of warrants	14,214,035	21,057	-	-	-	21,057
Private placement for cash	18,000,000	34,200	-	-	-	34,200
Private placement commission non-cash transaction	422,300	802	-	-	-	802
Transfer of contributed surplus on exercise of options	-	1,289	(1,289)	-	-	-
Stock based compensation	-	-	6,974	-	-	6,974
Issue costs (non-cash amount \$802)	-	(2,487)	-	-	-	(2,487)
(Loss) for the period	-	-	-	(2,789)	-	(2,789)
Other comprehensive (loss), net of tax	-	-	-	-	(305)	(305)
Balance December 31, 2007	80,977,663	\$ 100,159	\$ 11,770	\$ (11,008)	\$ 144	\$ 101,065

(See accompanying Notes)

FORTUNA SILVER MINES INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2007 AND FOR THE FIFTEEN MONTH PERIOD
ENDED DECEMBER 31, 2006
(Expressed in thousands of Canadian Dollars)

	Year ended December 31, 2007	15 month period ended December 31, 2006
OPERATING ACTIVITIES		
Net (loss) for the period	\$ (2,789)	\$ (4,348)
Items not involving cash		
Depletion and depreciation	5,640	739
Accretion expense	158	180
Future income tax	3,717	494
Stock based compensation	6,974	4,132
Unrealized (gain) on commodity contracts	(1,466)	-
Non-controlling interest	(92)	
Write-off of deferred exploration costs	12	40
(Gain) on disposal of investment	-	(26)
Loss on disposal of equipment	59	-
Foreign exchange (gain)	(515)	(272)
Changes in non-cash working capital items		
Accounts receivable and prepaid expenses	(527)	(2,256)
Inventories	(798)	(826)
Accounts payable	2,877	1,367
Payments (to) from related parties (Note 11)	(13)	19
Net cash from (used in) operating activities	13,237	(757)
FINANCING ACTIVITIES		
Proceeds on issuance of common shares	55,528	25,589
Capital lease obligations	(132)	(29)
Repayment of debt (Note 12)	(5,730)	(5,070)
Proceeds from loans	-	5,685
Net cash from financing activities	49,666	26,175
INVESTING ACTIVITIES		
Purchase of long-term investment	-	(1,000)
Mineral property expenditures	(10,515)	(20,657)
Value added taxes on purchase of property, plant and equipment	(1,033)	(3,302)
Property, plant & equipment expenditures	(5,795)	(4,668)
Proceeds from disposal of equipment	39	-
Net cash used in investing activities	(17,304)	(29,627)
INCREASE (DECREASE) IN CASH	45,599	(4,209)
Cash and cash equivalents – beginning of period	1,641	5,850
CASH AND CASH EQUIVALENTS – END OF PERIOD	\$ 47,240	\$ 1,641
Supplementary disclosure of cash flow information:		
Cash (received) paid for interest	\$ (1,504)	\$ 84
Cash paid for income taxes	\$ 608	\$ -

Non-cash transactions (Note 18)

(See accompanying Notes)

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED DECEMBER 31, 2007

(All amounts expressed in thousands of Canadian Dollars, except for share and per share amounts)

1. Nature and Continuance of Operations

Fortuna Silver Mines Inc. (the "Company") is engaged in silver mining and related activities, including exploration, extraction, and processing. The Company operates the Caylloma zinc/lead/silver mine in southern Peru and is currently developing the San Jose silver/gold project in Mexico.

The Company's continuing operations and the recoverability of amounts shown for its exploration stage mineral properties are dependent upon the availability of the necessary financing to complete the exploration and development of such mineral property interests, and upon future profitable production or proceeds from the disposition of its mineral property interests. Future profitable production is primarily dependent on the quality of ore resources, ability to obtain permits, future metal prices, operating and environmental costs, fluctuations in currency exchange rates, political risks and varying levels of taxation.

2. Significant Accounting Policies

In 2006, the Company changed its year-end from September 30 to December 31. The comparative figures reflect the 15 month period ended December 31, 2006.

a) Basis of presentation:

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). The consolidated financial statements include the accounts of the Company's wholly owned subsidiaries, Minera Bateas SAC (Bateas) and Fortuna Silver (Barbados) Inc. and of the Company's 76% interest in Compania Minera Cuzcatlan SA, a variable interest entity for which a non-controlling interest has been recorded to reflect the 24% interest of the Company's partner. All significant intercompany balances and transactions have been eliminated on consolidation.

b) Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Significant items subject to such estimates and assumptions include the fair values of financial instruments and derivatives, determination of mineral reserves, the carrying amount of mineral property, plant and equipment, assay grades of metal concentrates sold, valuation of inventories and future income taxes, recoverability of receivables, provisions for asset retirement obligation and reclamation, fair value estimation of acquisitions and stock-based awards. Actual results could differ from those estimates.

c) Revenue Recognition:

Revenue arising from the sale of metal concentrates is recognized when title and the significant risks and rewards of ownership of the concentrates have been transferred to the buyer. The passing of title to the customer is based on the terms of the sales contract and final commodity prices are set on a specified quotational period, either one or three months after delivery at the option of the customer. The Company's metal concentrates are provisionally priced at the time of sale based on the prevailing market price.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED DECEMBER 31, 2007

(All amounts expressed in thousands of Canadian Dollars, except for share and per share amounts)

2. Significant Accounting Policies (continued)

d) Cash and cash equivalents

Cash and cash equivalents include highly liquid investments with original maturities of ninety days or less.

e) Long-term investments

Long-term investments are those investments which the Company will be retaining for a period longer than one year. These investments are classified as available-for-sale and are recorded at fair value.

f) Property, Plant and Equipment

Property, plant and equipment are recorded at cost and are depreciated over the estimated economic life of the asset as follows:

Buildings, mine site	Life of mine
Buildings, other	20 – 30 years
Machinery and equipment	3 – 8 years
Furniture and other equipment	4 – 10 years
Vehicles	4 – 5 years

The expected remaining life of the mine as at December 31, 2007 is 9 years. Land is not depreciated. Equipment under capital lease is initially recorded at the present value of minimum lease payments at the inception of the lease.

Management reviews the carrying value of its property, plant, and equipment when events or changes in circumstances indicate that their carrying values may not be recoverable. Impairment of an asset is considered to exist if total estimated future cash flows on an undiscounted basis expected to be generated by the asset are less than the carrying amount of the asset. If a shortfall exists, the asset is written down to its fair value.

g) Mineral Properties

The Company defers the cost of acquiring, maintaining its interest, exploring and developing mineral properties when future inflow of economic benefits from the properties is probable and until such time as the properties are placed into production, abandoned, sold or considered to be impaired in value. Costs of producing properties, including capitalized interest are amortized on a unit-of-production basis over proven and probable reserves and costs of abandoned properties are written-off. Proceeds received from the sale of interests in mineral properties are credited to the carrying value of the mineral properties, with any excess included in operations. Write-downs due to impairment in value are charged to operations.

For operating mines all replacement and expansion exploration within the mineral deposit is capitalized and amortized on a unit-of-production basis over proven and probable reserves as part of the production cost.

Management reviews the carrying value of mineral properties when events or changes in circumstances indicate that their carrying values may not be recoverable. Amounts shown for properties represent costs incurred net of write-downs and recoveries, and are not intended to represent present or future values.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED DECEMBER 31, 2007

(All amounts expressed in thousands of Canadian Dollars, except for share and per share amounts)

2. Significant Accounting Policies (continued)

h) Asset Retirement Obligation

The fair value of an obligation associated with the retirement of a tangible long-lived asset is recorded in the period in which it is incurred and a reasonable estimate of the fair value can be made, with a corresponding increase to the carrying amount of the related asset. The liability is accreted over time for changes in the fair value of the liability through charges to accretion, which is included in depletion, depreciation and accretion expense. The costs capitalized to the related assets are amortized in a manner consistent with the depletion and depreciation of the related assets.

i) Inventories

Ore stockpile and finished goods inventories are valued at the lower of production cost and net realizable value. Production costs include all mine site costs. Materials and supplies are valued at weighted average cost less allowances for obsolescence.

j) Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the year that includes the date of substantive enactment. Future tax assets are recognized to the extent that they are considered more likely than not to be realized.

k) Stock-based Compensation

The Company has a share option plan which is described in Note 15. The Company records all stock-based compensation relating to options granted using the fair value method such that stock-based payments are measured at fair value and expensed over their vesting period with a corresponding increase to contributed surplus. Upon exercise of share purchase options, the consideration paid by the option holder, together with the amount previously recognized in contributed surplus, is recorded as an increase to share capital.

l) Basic and Diluted Loss Per Share

Basic loss per share ("LPS") is calculated by dividing the net loss applicable to common shareholders by the weighted average number of common shares outstanding for the year. Potentially dilutive outstanding options and warrants are excluded from the calculation of LPS, as they would be anti-dilutive.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED DECEMBER 31, 2007

(All amounts expressed in thousands of Canadian Dollars, except for share and per share amounts)

2. Significant Accounting Policies (continued)

m) Foreign Currency Translation

The Company's subsidiaries are accounted for as integrated foreign operations. Monetary items denominated in a foreign currency are translated into Canadian dollars at exchange rates prevailing at the balance sheet date and non-monetary items are translated at exchange rates prevailing when the assets were acquired or obligations incurred. Foreign currency denominated revenue and expense items are translated at the exchange rates prevailing at the transaction date. Gains or losses arising from the translations are included in operations except for gains or losses arising from translation of capitalized costs and costs of purchase of property, plant and equipment at exploration properties, in which case such foreign exchange gains or losses are capitalized.

n) Financial Instruments

The long-term investments are classified as available-for-sale and are recorded at their fair value, which is determined with reference to market value of underlying marketable securities. Derivative instruments are recorded at fair value, which is determined with reference to the market value of underlying commodities. All other financial instruments are recorded at cost, which approximates their fair value, due to the short-term maturity and high liquidity.

o) Risk Management

Interest rate risk

The Company holds cash and cash equivalents which earn interest at variable rates as determined by financial institutions.

Credit risk

The Company only places its cash with major financial institutions.

Foreign currency risk

The Company is exposed to currency risk in that its subsidiary operations are transacted in Peruvian Nuevo Soles, Mexican Pesos and the U.S. dollar. The Canadian dollar value of the assets and liabilities of the subsidiary denominated in these three currencies will fluctuate due to changes in foreign exchange. The Company does not use any hedging instruments to reduce its foreign currency exposure.

3. New Accounting Pronouncements

Canadian Institute of Chartered Accountants ("CICA") has issued three new standards which will affect the financial disclosures and results of operations of the Company for interim and annual periods beginning January 1, 2008. The company will adopt the requirements commencing in the interim period ended March 31, 2008. The adoption of these new standards is not expected to have any material impact on the Company's financial results.

a) Section 1535 – Capital Disclosures

This Section establishes standards for disclosing information about an entity's capital and how it is managed. Under this standard the Company will be required to disclose the following, based on the information provided internally to the entity's key management personnel:

- (i) qualitative information about its objectives, policies and processes for managing capital;
- (ii) summary quantitative data about what it manages as capital;

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED DECEMBER 31, 2007

(All amounts expressed in thousands of Canadian Dollars, except for share and per share amounts)

3. New Accounting Pronouncements (continued)

- (iii) whether during the period it complied with any externally imposed capital requirements to which it is subject; and
- (iv) when the company has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

b) Section 3031 - Inventories

This Section prescribes the accounting treatment for inventories and provides guidance on the determination of costs and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

c) Section 3862 – Financial Instruments – Disclosures

This Section replaces Section 3861 “Financial Instruments – Disclosure and Presentation” and requires entities to provide disclosure of quantitative and qualitative information in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance; and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and management's objectives, policies and procedures for managing such risks. Entities will be required to disclose the measurement basis or bases used, and the criteria used to determine classification for different types of instruments.

The Section requires specific disclosures to be made, including the criteria for:

- (i) designating financial assets and liabilities as held for trading;
- (ii) designating financial assets as available-for-sale; and
- (iii) determining when impairment is recorded against the related financial asset or when an allowance account is used.

4. Adoption of New Accounting Standards

On January 1, 2007, the Company adopted the provisions of the Canadian Institute of Chartered Accountants Handbook (“CICA HB”) Sections 1530 “Comprehensive Income”, 3251 “Equity”, 3855 “Financial Instruments – Recognition and Measurement”, 3861 “Financial Instruments – Presentation and Disclosure”, and 3865 “Hedges”. These sections address the classification, recognition and measurement of financial instruments and hedges in the financial statements and inclusion of other comprehensive income. These standards have been applied retrospectively with no restatement of comparative amounts for prior periods.

a) Comprehensive income

Section 1530 introduces comprehensive income, which consists of net income and other comprehensive income. Other comprehensive income represents changes in shareholders' equity during a period arising from transactions and other events and circumstances from non-owner sources and includes unrealized gains and losses on financial assets classified as available-for-sale. The components of comprehensive income are disclosed on the consolidated statements of operations and comprehensive loss.

b) Financial instruments

Section 3861 establishes standards for the presentation and disclosure of financial instruments. Section 3855 establishes standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. It requires that financial assets and

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED DECEMBER 31, 2007

(All amounts expressed in thousands of Canadian Dollars, except for share and per share amounts)

4. Adoption of New Accounting Standards (continued)

financial liabilities, including derivatives, be measured at fair value on initial recognition and recorded on the balance sheet. Measurement in subsequent period depends on whether the financial instrument has been classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables or other financial liabilities.

Financial assets and liabilities held-for-trading are measured at fair value with changes in those fair values recognized in net income. Financial assets and financial liabilities considered held-to-maturity, loans and receivables, and other financial liabilities are measured at amortized costs using the effective interest method of amortization. Available-for-sale financial assets are measured at fair value with unrealized gains and losses recognized in other comprehensive income. Investments in equity instruments classified as available-for-sale that do not have a quoted market price in an active market are measured at cost.

Derivative instruments, including embedded derivatives, are recorded on the balance sheet at fair value. Changes in the fair values of derivative instruments are recognized in net income with the exception of derivatives designated as effective cash flow hedges. Section 3865 establishes the standards for hedge accounting.

c) Impact upon adoption of CICA HB Section 1530, 3251, 3855, 3861 and 3865

As a result of adopting these new standards at January 1, 2007, the Company recorded an unrealized gain of \$449 resulting from the change in accounting for financial assets classified as "available-for-sale". Prior to adoption of these new standards these financial assets were stated at cost. The gain was recorded as a one-time cumulative adjustment to other comprehensive income (Note 16).

5. Derivatives

During October 2007, the Company entered into a series of put and call option commodity arrangements to secure a minimum price level on part of its zinc and lead metal production throughout the period November 2007 to December 2008. A long put and a long call refer to put and call options that have been bought by the Company, and a short call refers to call options that have been sold by the Company. Settlement of these options occurs monthly during the period from December 2007 until January 2009. No initial premium associated with these trades has been paid.

The following Zinc Asian Option contracts were entered into:

- 14 Long put options at strike price: USD 2,575/t, for the total of 2,800 tons
- 14 Short call options at strike price: USD 2,750/t, for the total of 2,800 tons
- 14 Long call options at strike price: USD 3,450/t, for the total of 2,800 tons

The following Lead Asian Option contracts were entered into:

- 14 Long put options at strike price: USD 3,000/t, for the total of 1,750 tons
- 14 Short call options at strike price: USD 3,300/t, for the total of 1,750 tons
- 14 Long call options at strike price: USD 4,300/t, for the total of 1,750 tons

As at December 31, 2007 the Company had 12 open options on each of the arrangements.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEAR ENDED DECEMBER 31, 2007

(All amounts expressed in thousands of Canadian Dollars, except for share and per share amounts)

5. Derivatives (continued)

The estimated fair value of the outstanding Asian Options of \$1,400 was determined based on using applicable valuation techniques for commodity options with reference to the published market prices for underlying commodities quoted at London Metal Exchange. This amount has been recorded as an unrealized gain on commodity contract as at December 31, 2007.

6. Accounts receivable and prepaid expenses

	December 31, 2007	December 31, 2006
Trade accounts receivable	\$ 409	\$ 1,562
Advances and other receivables	1,505	279
Prepaid expenses and deposits	137	60
	<u>\$ 2,051</u>	<u>\$ 1,901</u>

7. Inventories

Inventories consist of the following:

	December 31, 2007	December 31, 2006
Ore stock piles	\$ 466	\$ 78
Concentrate stock piles	159	165
Materials and supplies	1,068	583
	<u>\$ 1,693</u>	<u>\$ 826</u>

8. Long term investments

At December 31, 2007 and December 31, 2006 the Company owned 3,706,250 shares of Continuum Resources Ltd. As at December 31, 2006 these were stated at cost. With the adoption of financial instruments standards, the Company measures these investments at fair value (Note 4). The fair value was determined based on published share prices of underlying securities on the active market. On adoption of financial instruments standards, a cumulative adjustment was recorded in other comprehensive income to reflect the change in accounting policy. During the year ended December 31, 2007 the decrease in fair value of \$352 (\$305 net of taxes) has been recognized in other comprehensive loss for the period (Note 16).

	December 31, 2007	December 31, 2006
Fair value	\$ 908	\$ -
Cost	741	741
Unrealized gain (cumulative)	<u>\$ 167</u>	<u>\$ -</u>

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEAR ENDED DECEMBER 31, 2007

(All amounts expressed in thousands of Canadian Dollars, except for share and per share amounts)

9. Property, Plant & Equipment

Property, plant and equipment is comprised of the following:

	December 31, 2007		December 31, 2006	
	Cost	Accumulated Depreciation	Net book value	Net book value
Land	\$ 259	\$ -	\$ 259	\$ -
Machinery & equipment	8,222	1,034	7,188	4,526
Buildings	2,989	409	2,580	2,457
Furniture & other equipment	912	104	808	372
Transport units	524	75	449	174
Equipment under capital lease	1,035	71	964	169
Work in progress	1,421	-	1,421	108
	<u>\$ 15,362</u>	<u>\$ 1,693</u>	<u>\$ 13,669</u>	<u>\$ 7,806</u>

10. Mineral Properties

Mineral properties are located in Peru and Mexico and are comprised of the following:

	December 31, 2007			December 31, 2006	
	Cost	Depletion	Write-off	Net	Net
Peru - Caylloma	\$ 31,063	\$ 4,795	\$ -	\$ 26,268	\$ 23,965
Mexico – San Jose	26,070	-	-	26,070	18,564
Other	12	-	12	-	12
	<u>\$ 57,145</u>	<u>\$ 4,795</u>	<u>\$ 12</u>	<u>\$ 52,338</u>	<u>\$ 42,541</u>

The carrying amount of mineral properties at San Jose includes \$336 of capitalized interest on loans (Note 12). Additions to mineral properties are comprised of development and exploration costs capitalized and consist of \$6,526 at Caylloma and \$7,506 at San Jose properties for the year ended December 31, 2007. Included in additions to San Jose mineral properties are depreciation of equipment involved in construction work of \$57 (2006: \$nil), and general and administrative costs to develop the mine of \$929 (2006: \$nil).

San Jose Project, Mexico

The San Jose Project is owned and operated by Compañía Minera Cuzcatlan (“Cuzcatlan”), a company owned 76% by the Company and 24% by Continuum Resources Ltd (“Continuum”). The Company is the operator of the work programs and the Company and Continuum must contribute to the costs thereof in proportion to its ownership percentage in Cuzcatlan.

Cuzcatlan has been accounted for as a variable interest entity, as defined in CICA Accounting Guideline 15 “Consolidation of Variable Interest Entities” and has been consolidated from the date of acquisition. A non-controlling interest of \$6,593 has been recorded as at December 31, 2007 (December 31, 2006 - \$3,227).

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11. Related Party Transactions

The Company incurred charges from directors, officers, and companies having a common director or officer as follows:

	Year ended December 31, 2007	15 Months ended December 31, 2006
Mineral property costs – geological fees	\$ 45	\$ 174
Consulting fees	188	75
Salaries and wages	108	16
Management fees	266	146

These charges were measured at the exchange amount, which is the amount agreed upon by the transacting parties.

At December 31, 2007, due to related parties consists of \$14 (December 31, 2006 - \$27) owing to an officer and to companies with a common director. These amounts were incurred as a result of shared administrative costs. These amounts are unsecured, non-interest bearing and payable in the normal course of business.

12. Loans and leases

On November 21, 2006 the Company borrowed \$4,600 at an interest rate of 12% from Quest Capital Corporation in connection with the acquisition of the San Jose property. The loan was due on May 30, 2007, however the \$4,600 plus interest of \$25 was paid back on January 15, 2007.

On October 30, 2006 a revolving credit line of US\$ 950 with a CDN value of \$1,079 as of December 31, 2006 and an interest rate of Libor + 1.5% plus a variable utilization fee, was taken for working capital purposes from Traxys North America. The amount of the credit line of \$1,079, plus interest and fees of \$41 was paid back on February 8, 2007.

At December 31, 2007 the Company has capital lease obligations of \$872 (December 31, 2006 - \$142) including a current portion of \$439 (December 31, 2006 - \$45). These are related to the acquisition of mining equipment, transport units and buildings. These obligations have terms of 24, 25 months and 36 months, have expiry dates ranging from October 5, 2009 to December 15, 2010 and bear interest at rates ranging from 8.16% to 8.92%. During the year ended December 31, 2007, \$132 was paid on the capital leases (15 month period ended December 31, 2006: \$29). During the year ended December 31, 2007 the Company assumed new capital lease obligations of \$862 (15 month period ended December 31, 2006: \$171)

13. Asset Retirement Obligation

The Company has recorded an asset retirement obligation of \$1,916 as of December 31, 2007 as a result of accretion of the previously recorded asset retirement obligation of \$1,758 as of December 31, 2006 by \$158. The accretion expense was calculated over the year using a rate of 9%. The initial amount was based on an estimate prepared by an independent third party at the time of acquisition as to the cost of reclamation associated with the Caylloma property. The Company is currently reviewing its reclamation obligations at the property in light of changing regulations and on the basis of further data in respect of the mine life.

In view of the uncertainties concerning environmental reclamation, the ultimate cost of reclamation activities could differ materially from the estimated amount recorded. The estimate

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13. Asset Retirement Obligation (continued)

of the Company's asset retirement obligation relating to the Caylloma mine is subject to change based on amendments to laws and regulations and as new information regarding the Company's operations becomes available.

Future changes, if any, to the estimated liability as a result of amended requirements, laws, regulations, operating assumptions, estimated timing and amount of obligations may be significant and would be recognized prospectively as a change in accounting estimate. Any such change would result in an increase or decrease to the liability and a corresponding increase or decrease to the mineral property, plant and equipment balance.

14. Income Tax

a) Income tax expense differs from the amount that would be computed by applying the Canadian statutory income tax rate of 34.12% (2006 – 34.12%) to loss before income taxes and non-controlling interest. The reasons for the differences are as follows:

	2007	2006
Income (loss) before income taxes and non-controlling interest	\$ 1,380	\$ (3,854)
Statutory income tax rate	34.12%	34.12%
Expected income tax (recovery)	\$ 471	\$ (1,315)
Items (deductible) non-deductible for income tax purposes	(74)	1,430
Differences in tax rates in foreign jurisdictions and non-recognition benefits	3,202	(604)
Change in valuation allowance	662	983
Total income taxes	\$ 4,261	\$ 494
Represented by:		
Current income tax	\$ 544	\$ -
Future income tax	3,717	494

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14. Income Tax (continued)

- b) The tax effects of temporary differences that give rise to significant portions of the future tax assets and future tax liabilities at December 31, 2007 and December 31, 2006 are presented below:

	2007		2006
Future income tax assets (all arising in Canada):			
Non-capital losses	\$ 1,275	\$	725
Financing costs	657		473
Undepreciated capital cost in excess of accounting net book value and other	4		-
Mineral properties	436		512
Valuation allowance	(2,372)		(1,710)
	-		-
Future income tax liabilities:			
Long-term investments - Canada	(23)		-
Mineral properties – Peru	(5,910)		(2,624)
Mineral properties – Mexico	(2,136)		(2,286)
	(8,069)		(4,910)
Net future income tax (liabilities)	\$ (8,069)	\$	(4,910)

As at December 31, 2007, the Company had available the following amounts for deduction against future earnings in Canada:

Non-capital losses, expiring as follows:			
2008 to 2010		\$	276
2014 to 2015			1,683
2026 to 2027			2,765
			4,724
Financing costs		\$	2,433

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15. Share Capital

a) Authorized: Unlimited common shares without par value

	Number of shares	Amount
Balance, September 30, 2005	20,083,465	\$ 12,164
Exercise of options	650,000	424
Exercise of warrants	6,124,631	5,601
Private placement for cash	16,700,000	22,050
Private placement commission non-cash transaction (Note 18)	760,261	1,140
Property acquisition non-cash transaction (Note 18)	1,897,621	2,714
Property finders fee non-cash transaction (Note 18)	50,000	68
Property acquisition non-cash transaction (Note 18)	168,417	285
Loan fee (Note 18)	153,333	276
Transfer of contributed surplus on exercise of options	-	214
Less issue costs (non-cash amount \$1,140)	-	(1,595)
Balance, December 31, 2006	46,587,728	43,341
Exercise of options	1,753,600	1,957
Exercise of warrants	14,214,035	21,057
Private placement for cash	18,000,000	34,200
Private placement commission non-cash transaction (Note 18)	422,300	802
Transfer of contributed surplus on exercise of options	-	1,289
Less issue costs (non-cash amount \$802)	-	(2,487)
Balance, December 31, 2007	<u>80,977,663</u>	<u>\$ 100,159</u>

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15. Share Capital (continued)

b) Stock Options

A summary of stock options granted and exercised under the Company's stock option plan is as follows:

	Year ended December 31, 2007		15 Month period ended December 31, 2006	
	Number of Options	Weighted Average Exercised Price	Number of Options	Weighted Average Exercised Price
Outstanding, beginning of period	3,765,000	\$ 1.62	860,000	\$ 0.56
Granted	4,355,000	2.82	3,555,000	1.70
Exercised	(1,321,100)	1.48	(650,000)	0.65
Expired/cancelled	(112,500)	2.56	-	-
Outstanding, end of period	<u>6,686,400</u>	<u>\$ 2.24</u>	<u>3,765,000</u>	<u>\$ 1.62</u>

The following stock options were outstanding and exercisable at December 31, 2007:

Number of shares	Exercise Price \$	Expiry Date
39,000	0.37	December 2, 2009
30,000	0.80	July 24, 2010
285,000	1.35	February 5, 2016
451,000	2.29	March 30, 2016
60,000	1.75	May 8, 2016
200,000	1.75	May 22, 2016
280,000	1.55	July 5, 2016
860,000	1.66	July 10, 2016
225,000	1.61	September 13, 2016
20,000	1.90	November 20, 2016
50,000	1.96	November 23, 2016
1,391,400	2.22	January 11, 2017
80,000	2.75	February 6, 2017
15,000	3.09	April 22, 2017
50,000	3.10	May 31, 2017
50,000	3.10	June 17, 2017
50,000	3.05	June 27, 2017
2,025,000	3.22	July 2, 2017
250,000	2.97	September 23, 2017
250,000	2.82	October 9, 2010
25,000	3.10	October 24, 2017
<u>6,686,400</u>		

6,286,400 options have vested as at December 31, 2007. The average remaining life of the outstanding options at December 31, 2007 is 8.7 years.

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15. Share Capital (continued)

c) Warrants

A summary of share purchase warrants issued and exercised is as follows:

	Year ended December 31, 2007		15 Month period ended December 31, 2006	
	Number of Warrants	Weighted Average Exercise Price	Number of Warrants	Weighted Average Exercise Price
Outstanding, beginning of period	20,566,185	\$ 1.23	13,114,117	\$ 0.91
Issued	10,559,725	2.30	13,576,699	1.40
Exercised	<u>(14,646,535)</u>	<u>1.44</u>	<u>(6,124,631)</u>	<u>0.91</u>
Outstanding, end of period	<u>16,479,375</u>	<u>\$ 1.89</u>	<u>20,566,185</u>	<u>\$ 1.23</u>

The following share purchase warrants were outstanding at December 31, 2007:

Number of warrants	Exercise Price \$	Expiry Date
4,322,596	1.850	March 23, 2008
862,117	0.345	June 27, 2010
1,613,238	0.345	November 17, 2010
960,969	2.300	July 11, 2008
8,720,455	2.300	July 11, 2008
<u>16,479,375</u>		

d) Stock-Based Compensation

The Company uses the fair value based method of accounting for share options granted to consultants, directors, officers and employees. The non-cash compensation charge of \$6,974 recognized for the year ended December 31, 2007 (15 month period ended December 31, 2006: \$4,132) is associated with the granting of options to a consultant, directors and employees. These compensation charges have been determined under the fair value method using the Black-Scholes option pricing model with the following assumptions:

	Year ended December 31, 2007	15 month period ended December 31, 2006
Risk-free interest rate	4.04% - 4.67%	2.93% - 4.59%
Expected stock price volatility	59% - 68%	43% - 92%
Expected term in years	5 & 10	5 & 10
Expected dividend yield	0%	0%

Option pricing models require the input of highly subjective assumptions including the estimate of the share price volatility, risk-free interest rate and expected life of the options. Changes in the subjective input assumptions can materially affect the fair value estimate, and therefore the existing models do not necessarily provide a reliable single measure of the fair value of the Company's stock options.

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16. Accumulated other comprehensive income

	December 31, 2007
Balance at December 31, 2006	\$ -
Cumulative impact of accounting changes, net of tax (Note 4)	449
Adjusted balance January 1, 2007	449
Unrealized (loss) on available-for-sale long term investment, net of tax (Note 8)	(305)
Balance at December 31, 2007	<u>\$ 144</u>

17. Segmented Information

The Company is currently engaged in mining and the development of mineral properties. Details on a geographical basis are as follows:

	Canada	Peru	Mexico	Other	Total
Year ended December 31, 2007					
Revenue	\$ -	\$ 31,667	\$ -	\$ -	\$ 31,667
Operating (loss) income	\$ (8,836)	\$ 8,972	\$ -	\$ (29)	\$ 107
As at December 31, 2007					
Property, plant & equipment	\$ 7	\$ 9,252	\$ 4,407	\$ 3	\$ 13,669
Total assets	\$ 40,273	\$ 49,297	\$ 34,155	\$ 721	\$ 124,446
15 month period ended					
December 31, 2006					
Revenue	\$ -	\$ 3,372	\$ -	\$ -	\$ 3,372
Operating (loss) income	\$ (5,731)	\$ 771	\$ -	\$ (40)	\$ (5,000)
As at December 31, 2006					
Property, plant & equipment	\$ 9	\$ 7,792	\$ 2	\$ 3	\$ 7,806
Total assets	\$ 2,589	\$ 36,762	\$ 19,829	\$ 14	\$ 59,194

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18. Supplementary Disclosure of Non-cash Transactions

Investing and financing activities that do not have a direct impact on current cash flows are excluded from the statements of cash flows.

The following non-cash transactions occurred:

	15 month period ended December 31, 2006	
	Number of shares	Amount
Shares issued for property acquisition, previously booked as an obligation	1,897,621	\$ 2,714
Warrants issued for property acquisition, previously booked as an obligation	1,613,238	1,871
Shares issued for property finders fees	50,000	68
Shares issued for commission on private placement	760,261	1,140
Shares issued for property acquisition	168,417	284,625
Shares issued to Continuum for property acquisition	1,293,750	284,625
Shares issued as a consideration on Quest loan	153,333	275,999
Fair value of options exercised	-	214

	Year ended December 31, 2007	
	Number of shares	Amount
Shares issued for commission on private placement	422,300	\$ 802
Purchase of equipment on a deferred payment plan	-	847
Fair value of options exercised	-	1,289

19. Commitments

The Company has a thirteen month contract with one customer who purchases the full production from the Company's operating Caylloma mine. Under the contract, the Company is committed to supply 4,800 tons of lead concentrate and 7,200 tons of zinc. As at December 31, 2007, the Company fulfilled this commitment.

A processing plant was purchased in Mexico in the first quarter of 2007 for US\$2,250,000 to be paid in three installments of US\$750,000. The first installment was paid on February 1, 2007 and the second installment was paid on August 1, 2007. The final installment was paid on February 1, 2008 and is included in accounts payable and accrued liabilities at December 31, 2007.

The Company has a contract to guarantee power supply at its Caylloma mine. Under the contract the seller is obligated to deliver a "maximum committed demand" (for the present term this stands at 2,800 Kw) and Bateas is obligated to purchase subject to exemptions under provisions of "Force Majeure". The contract is automatically renewed every two years for a period of 10 years. Renewal can be avoided without penalties by notifying 10 months in advance of renewal date. Tariffs are established yearly by energy market regulator in accordance with applicable regulations in Peru.

FORTUNA SILVER MINES INC.

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20. Subsequent Events

Subsequent to December 31, 2007, the Company received \$34 from the exercise of 21,400 options and \$7,997 from the exercise of 4,322,596 warrants.

On February 6, 2008 options were granted to purchase up to 250,000 common shares exercisable for 10 years at a price of \$2.52 per share.

During January 2008 the Company entered into additional derivative contracts spread out evenly over the period from February 2008 to January 2009 (Note 5).

The following Zinc Forward sale contract was entered into on a SWAP basis:

- USD 2,360/t, for the total of 1,700 tons

The contract is settled against the arithmetic average of zinc spot prices over the month in which the contract matures.

The following Lead Asian Option contracts were entered into:

- Long put options at strike price: USD 2,575/t, for the total of 1,025 tons
- Short call options at strike price: USD 2,760/t, for the total of 1,025 tons
- Long call options at strike price: USD 3,300/t, for the total of 1,025 tons

21. Comparative Figures

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