

## AUDITORS' REPORT

TO THE SHAREHOLDERS OF  
DARNLEY BAY RESOURCES LIMITED

We have audited the balance sheets of Darnley Bay Resources Limited as at December 31, 2004 and 2003, and the statements of mineral properties and related expenditures, loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2004 and 2003 and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

(Signed) Edmund Cachia & Co..  
CHARTERED ACCOUNTANTS

Toronto, April 29, 2005



**DARNLEY BAY RESOURCES LIMITED**  
**FINANCIAL STATEMENTS**

4TH QUARTERS (unaudited) and YEARS (audited) ENDED DECEMBER 31, 2004 and 2003

BALANCE SHEET	December 31	
	2004	2003
	\$	\$
Cash	2,099	753
Goods and services taxes (GST) recoverable	11,348	26,386
Current assets	13,447	27,139
Deposits	233,468	437,193
Mineral property and related expenditures	6,401,310	6,389,649
<b>Total assets</b>	<b>6,648,225</b>	<b>6,853,981</b>
Accounts payable and accrued liabilities	2,077,359	1,668,691
Advance from joint venture partner		290,000
Future income taxes (note 6)	867,145	953,701
Capital stock (note 5)	18,006,510	17,670,837
Deficit	(14,302,789)	(13,729,248)
Shareholders' equity	3,703,721	3,941,589
Liabilities and shareholders' equity	6,648,225	6,853,981

STATEMENT OF MINERAL PROPERTIES AND RELATED EXPENDITURES	4th Quarter		Year		Cumulative December 31, 2004 *
	2004	2003	2004	2003	2004 *
	\$	\$	\$	\$	\$
Concession and permit fees to Inuvialuit and other agencies (note 3)	18,191	98,052	85,520	300,434	3,841,146
Professional and technical services provided by geophysicists, geologists and others	1,172	58,074	42,983	90,884	2,271,131
Technical services provided by management	19,391	22,683	83,341	87,158	1,181,463
Legal fees applicable to exploration agreements	19,018	7,500	(7,500)	27,500	225,071
Travel and project presentations			2,675	55	289,796
Wages and accomodation facilities		5,250		3,270	992,958
Air charters and fuel					2,090,663
Site administration				119	205,705
Equipment and supplies	2,287	25,870	1,360	26,523	860,379
Drilling contracts					890,186
Environmental surveys					249,530
<b>Total expenditures for period</b>	<b>60,059</b>	<b>217,429</b>	<b>208,379</b>	<b>535,943</b>	<b>13,098,028</b>
Write down on mineral properties expenditures	(196,718)	(6,500,000)	(196,718)	(6,500,000)	(6,696,718)
Cumulative expenditures beginning of period	6,537,969	12,672,220	6,389,649	12,353,706	
<b>Cumulative expenditures at end of period</b>	<b>6,401,310</b>	<b>6,389,649</b>	<b>6,401,310</b>	<b>6,389,649</b>	<b>6,401,310</b>

The accompanying notes are an integral part of these financial statements

\* Cumulative amounts are from commencement of operations in 1993

Approved by the Board:

(Signed) Leon La Prairie, Director (Signed) William Allen, Director

	4th Quarter		Year		Cumulative
	2004	2003	2004	2003	December 31, 2004 *
	\$	\$	\$	\$	
<b>STATEMENT OF LOSS AND DEFICIT</b>					
Management and administrative services	36,058	50,627	178,434	215,891	1,845,973
Consultants					606,269
Legal and audit	1,018	22,675	66,730	46,275	722,759
Promotion		287	2,145	2,926	410,353
Communications	2,526	2,757	8,429	9,960	154,508
Rent	32,640	40,473	126,627	161,903	840,808
Stock transfer and shareholders' expenses	16,819	1,550	39,736	36,575	350,114
Office supplies and miscellaneous	2,511	1,551	17,281	8,331	270,228
Depreciation office equipment					30,736
Insurance					17,748
Capital tax				6,342	70,751
Provision for uncollected receivable					55,295
Interest and other financial expenses	14,495	2,429	23,997	11,070	83,391
Write down on mineral properties expenditures	196,718	6,500,000	196,718	6,500,000	6,696,718
<b>LOSS BEFORE INCOME TAXES</b>	<b>302,785</b>	<b>6,622,349</b>	<b>660,097</b>	<b>6,999,273</b>	<b>12,155,651</b>
Future income tax (reduction) payable	(86,556)	(2,625,641)	(86,556)	(2,625,641)	867,145
<b>NET LOSS FOR THE PERIOD</b>	<b>216,229</b>	<b>3,996,708</b>	<b>573,541</b>	<b>4,373,632</b>	<b>13,022,796</b>
Deficit at beginning of the period	14,086,560	9,959,194	13,729,248	9,357,839	
Cost of issuing shares		(226,654)		(2,223)	1,279,993
<b>DEFICIT AT END OF THE PERIOD</b>	<b>14,302,789</b>	<b>13,729,248</b>	<b>14,302,789</b>	<b>13,729,248</b>	<b>14,302,789</b>
<b>LOSS PER SHARE (cents)</b>	<b>0.006</b>	<b>0.107</b>	<b>0.016</b>	<b>0.124</b>	
<b>STATEMENT OF CASH FLOWS</b>					
Net loss for the period	(216,229)	(3,996,708)	(573,541)	(4,373,632)	(13,022,796)
Depreciation					30,736
Write down mineral properties net of taxes	196,718	6,500,000	196,718	6,500,000	6,696,718
Future income tax (reduction) payable	(86,556)	(2,625,641)	(86,556)	(2,625,641)	867,145
(Increase) decrease prepaid expenses		13,491			
Advance from (repayment to) joint venture partner		290,000	(203,725)	290,000	
(Increase) decrease in GST recoverable	(8,256)	(12,397)	15,037	(17,571)	(11,348)
Increase (decrease) in accounts payable	174,802	335,311	322,394	454,580	2,077,359
<b>CASH USED IN OPERATING ACTIVITIES</b>	<b>60,479</b>	<b>504,056</b>	<b>(329,673)</b>	<b>227,736</b>	<b>(3,362,186)</b>
Purchase of fixed assets					(30,736)
(Increase) decrease permits and security deposits		(287,193)	203,725	(266,592)	(233,468)
Increase mineral property expenditures	(60,059)	(217,429)	(208,379)	(535,943)	(13,098,028)
<b>CASH USED IN INVESTING ACTIVITIES</b>	<b>(60,059)</b>	<b>(504,622)</b>	<b>(4,654)</b>	<b>(802,535)</b>	<b>(13,362,232)</b>
Issue of common shares			335,673	545,956	18,006,510
Cost of issuing shares taxes excluding taxes applicable to flow-through shares				2,223	(1,279,993)
<b>CASH FROM FINANCING ACTIVITIES</b>			<b>335,673</b>	<b>548,179</b>	<b>16,726,517</b>
<b>INCREASE (DECREASE) IN CASH</b>	<b>420</b>	<b>(566)</b>	<b>1,346</b>	<b>(26,620)</b>	<b>2,099</b>
Cash at beginning of the period	1,679	1,319	753	27,373	
<b>CASH AT END OF THE PERIOD</b>	<b>2,099</b>	<b>753</b>	<b>2,099</b>	<b>753</b>	

The accompanying notes are an integral part of these financial statements

**DARNLEY BAY RESOURCES LIMITED**  
**NOTES TO FINANCIAL STATEMENTS**

For the Fourth Quarters (unaudited) and Years (audited)  
ended December 31, 2004 and 2003

**1 -NATURE OF OPERATIONS**

The objective of Darnley Bay Resources Limited is to explore for nickel, copper and platinum/palladium group elements and diamond deposits within and surrounding the geophysical anomaly centred on the Hamlet of Paulatuk in the Inuvialuit Settlement Region on the coast of the Arctic Ocean in the Northwest Territories of Canada. The Company has a working capital deficiency of \$1,830,444. The Company is in the development stage and the recovery of amounts capitalized as Mineral Property and Related Expenditures is dependent upon the discovery of economically recoverable ore reserves, the ability of the Company to obtain financing to complete the necessary exploration and development, and obtaining future profitable production or proceeds from the disposition thereof. These financial statements have been prepared on a going concern basis which assumes continuity of operations and realization of assets and settlement of liabilities in the normal course of business.

**2 -SIGNIFICANT ACCOUNTING POLICIES:**

**MINERAL PROPERTY AND RELATED EXPENDITURES**

Mineral Property and Related Expenditures consist of costs of acquiring claims and exploratory expenditures. These costs are deferred, or capitalized, until commencement of commercial mining operations, when the deferred costs applicable to the specific property will be amortized on the unit of production basis. If in any year, the interests in specific properties are disposed of, or abandoned, the applicable deferred expenditures will be written off in that year.

**FINANCIAL INSTRUMENTS**

Financial instruments, consisting of current assets and liabilities, are stated at cost. Due to the short-term nature of these instruments, cost approximates fair market value.

**INCOME TAXES**

Future income tax assets and liabilities are determined based on differences between the financial statements carrying values and their respective income tax basis generally using the enacted income tax rates at each balance sheet date. Future income assets also arise from unused loss carry forwards and other deductions. The amount of the future income tax asset recognized is limited to the amount that is more likely than not to be realized. The estimated realizable amount is reviewed annually and adjusted, if necessary, by use of a valuation allowance.

**STOCK OPTION COMPENSATION**

Effective January 1, 2003, the Company adopted, on a prospective basis, the fair value method of accounting for all stock option awards. Applying this method, the Company recognizes compensation expense for all stock options awarded subsequent to December 31, 2002, based on the fair value of the options on the date of grant which is determined using the Black Scholes option pricing model. The fair value of the options is expensed over the vesting period of the option. The Company recognized no compensation for stock options issued before January 1, 2003. Options presently outstanding are not exercisable until May 4, 2005 at which date the options will be recorded as stock-based compensation expense.



### 3 - AGREEMENTS & MINERAL PROPERTY AND RELATED EXPENDITURES

#### AGREEMENTS WITH INUVIALUIT LAND CORPORATION (“INUVIALUIT”)

##### Prior Agreements with the Inuvialuit

The Company has had two prior agreements, dated March 16, 2001, with the Inuvialuit. One dealt with base metals, the other with diamonds. The agreements covered an area of about 14,000,000 acres from latitude 68' north to 70' north and longitudes 120' 40 minutes west to 128' west. Of this area, the Inuvialuit own the mineral rights in 450,000 acres centered around Paulatuk (the “Concession Land”). The rest of the area was termed the Area of Mutual Interest. The Company’s rights in the Concession Lands have ended, and certain of the lands in the area of mutual interest have been abandoned and accordingly, the Company wrote down the mineral properties interest by \$6,500,000 in 2003. In the Area of Mutual Interest, the Company can acquire and hold prospecting permits and mining claims which are issued by the Crown. Except where the Company enters into new agreements with the Inuvialuit, the rights of the Inuvialuit in the Area of Mutual Interest are to continue under certain circumstances. Under the agreements, in the Area of Mutual Interest, the Inuvialuit are entitled to a 2% royalty, where the Crown royalties apply. (The Inuvialuit can hold certain claims in the Area of Mutual Interest in which there is a 15 year deferral of Crown royalties. In such cases the Inuvialuit will receive an additional 4% royalty while the deferral applies).

##### New Agreement with the Inuvialuit

The Company/Diadem joint venture, (outlined below) on February 4, 2004 entered into a letter agreement with the Inuvialuit under which the Company and Diadem will enter into a Cooperation and Benefits Agreement with the Inuvialuit. This agreement covers an area in the Inuvialuit Settlement Region around Paulatuk of about 57,000 square kilometers (excluding the area around Paulatuk in which the Inuvialuit own the mineral rights and excluding the Tukut Nogait National Park).

The agreement is for 5 years from January 1, 2004 with provisions for renewal and termination consistent with the joint venture’s mining rights in the area. The joint venture will be granted access to the Inuvialuit lands to conduct exploration, development and extraction operations for rough diamonds. The joint venture will be required to obtain all necessary Inuvialuit permits and approvals, and will pay the fees and charges under the Inuvialuit Rules with a minimum amount payable each year of \$50,000. The joint venture is to incur at least \$2 million of work by June 30, 2005. The Inuvialuit will receive a 2% diamond royalty on mining rights exploited by the joint venture. (The Inuvialuit can hold certain claims in the area in which there is a 15 year deferral of Crown royalties. In such cases the Inuvialuit will receive an additional 4% royalty while the deferral applies.) If the joint venture completes a positive feasibility, the Inuvialuit have the right to acquire up to a 10% participating interest by paying the corresponding percentage of the cost of the feasibility study.

#### JOINT VENTURE AGREEMENT WITH DIADEM RESOURCES LTD (“DIADEM”)

On June 24, 2003, the Company entered into a letter agreement with Carnarvon Capital Corporation (“Carnarvon”) for joint venture diamond exploration in a corridor measuring 150 miles by 95 miles (approximately 8 million acres) near Paulatuk in the Inuvialuit Settlement Region in the Northwest Territories. The principal terms are as follows:

- Carnarvon is to raise \$5 million to explore for diamonds. The funds are to be spent by June 30, 2006. When that is done, Carnarvon will be entitled to select up to 2.5 million acres of the corridor for further exploration, and Carnarvon will have earned an undivided 50% participating interest in the selected lands, with the Company holding the other 50%. The interests of Carnarvon and the Company will be subject to such equity rights as may be held by the Inuvialuit, and by such third parties as may receive rights if land is acquired from third parties.
- If there is a decision to carry out a feasibility study on the lands selected by Carnarvon, it will have the right to fund the feasibility study, and if the property is placed into commercial production Carnarvon’s interest will increase to 75% and the Company’s interest will decrease to 25%.
- When the \$5 million is spent, the parties will allocate at least \$2.5 million of the \$5 million to the selected lands. As to the portion of the \$5 million that is not allocated to the selected lands, Carnarvon will be entitled either to convert that amount to common shares of the Company at the then market price, subject to regulatory approval, or to convert that amount (in amounts of at least \$1 million) into a diamond royalty equal to 1% for each full \$1 million spent and not

allocated to the select lands. The Company will have the right to purchase such a royalty for \$1.5 million for each 1% of royalty if the purchase is made within 90 days of a bankable feasibility study, or thereafter for \$2.5 million if the purchase is within 90 days of the start of commercial production.

- When Carnarvon arranges the first \$2 million of the \$5 million, the Company will issue 500,000 common shares to Carnarvon subject to regulatory approval.

Subsequently the Company agreed to the transfer by Carnarvon of its interest in the agreement to Diadem and to change the time by which the \$5 million exploration costs are to be incurred from June 30, 2006 to December 31, 2006 and as the original agreement involved only the area north of the 68<sup>th</sup> parallel, the joint venture was extended south of the 68<sup>th</sup> parallel. In this expanded joint venture area, the Company and Diadem each have a 50% interest (with Diadem having the right to go to a 75% interest by financing a feasibility study for a diamond mine). In the area of the expanded joint venture, the Company and Diadem are to finance exploration costs equally, subject to dilution for non-participation.

#### SUBSEQUENT AMENDMENTS TO AGREEMENTS WITH THE INUVIALUIT & DIADEM RESOURCES

As referred to under the “New Agreement with the Inuvialuit”, at least \$2 million of expenditures was to be undertaken under the joint venture between the Company and Diadem by June 30, 2005. On March 1, 2005 the Inuvialuit extended the date from June 30, 2005 to September 30, 2005.

Effective March 16, 2005 the joint venture agreement with Diadem has been revised. Diadem’s earn-in expenditure requirements on lands north of the 68<sup>th</sup> parallel is reduced to a further \$2,100,000 by December 31, 2007. Previously the commitment was for \$5 million by December 31, 2006. The \$2.1 million is over and above approximately \$1 million spent by Diadem to-date. Also under the revised joint venture agreement, the Company has also renounced, in favour of Diadem, exploration for diamonds south of the 68<sup>th</sup> parallel.

#### OTHER AGREEMENT

The Company has a lease with SPE Operations Ltd covering rental of the Company’s head office. The lease expires on June 30, 2005 and currently the Company is negotiating renewal of the lease. Under the lease the Company pays a basic rent plus operating costs. The future minimum lease payments are \$83,500 in 2005.

#### 4. RELATED PARTY TRANSACTIONS

Related party transactions consist of compensation paid, or payable, to the Company’s senior officers and directors for management and professional services. The lack of available funds restricts cash compensation on a regular basis and settlement of arrears has been made from time to time, in the past, by the issue of common shares, issued at prevailing market values or greater. The Company’s accounts includes the following compensation to the related parties; for 2004 and 2003 and the balances remaining unpaid to them as at December 31, 2004.

Chief executive officer / director	2004	\$100,000	2003	\$102,000	\$164,939 unpaid
Chief financial officer	2004	\$78,000	2003	\$79,500	\$98,998 unpaid
Corporate secretary / director	2004	\$31,725	2003	\$48,510	\$40,158 unpaid
Director (geophysicist)	2004	\$13,571	2003	\$60,025	\$13,571 unpaid
Director (lawyer)	2004	\$52,425	2003	\$38,500	\$62,371 unpaid

The unpaid balances are as at December 31, 2004

#### 5 - CAPITAL STOCK

(a) Authorized:

An unlimited number of common shares

(b) Issued and outstanding

	Number	\$
Balance, December 31, 2002	31,017,447	17,124,881
Issued in 2003		
Exercise of common share purchase warrants	969,000	199,690
Private placements	<u>3,337,660</u>	<u>346,266</u>
Balance, December 31, 2003	35,324,107	17,670,837
Issued in 2004		
Private placements	<u>1,792,499</u>	<u>335,673</u>
Balance, December 31, 2004	<u>37,116,606</u>	<u>18,006,510</u>

The subscription prices for 1,792,499 shares issued in 2004 were; 296,000 at \$0.14, 499,999 at \$0.15 and 996,500 at \$0.22. For the 4,306,660 shares issued in 2003, the subscription prices were; 3,012,660 at \$0.10, 125,000 at \$0.12, 342,000 at \$0.15, 267,000 at \$0.17, 140,000 at \$0.20 and 420,000 at \$0.25.

(c) Options and commitment for issue of shares

The Company maintains a Stock Option Plan for the benefit of directors, officers, employees, consultants and other service providers of the Company in order to assist the Company in attracting, retaining, and motivating such persons by providing them with the opportunity, through stock options to acquire an increased proprietary interest in the Company. Under the plan, options are non-assignable and may be granted for a term not exceeding five years. The number of common shares that may be reserved for issue under the plan shall not exceed 10% of the common shares outstanding with no more than 5% applicable to any one optionee in any 12 month period. The exercise price of an option may not be lower than the closing price of the common shares on the TSX Venture Exchange, subject to applicable discounts, on the business day immediately preceding the date the option is granted. The options are non-transferable. Outstanding options may be adjusted by the Board of Directors in certain events, as to exercise price and number of common shares, to prevent dilution or enlargement. On November 5, 2004 the Company, pursuant to its stock option plan, granted options to its directors and officers to purchase up to a total of 3,600,000 shares at an issue price of \$0.13 per share. The options are not exercisable until May 4, 2005 and expire on November 4, 2009.

Under its joint venture agreement with Diadem Resources Ltd. (previously with Carnarvon Capital Corporation), upon the completion by Diadem of the first \$2,000,000 of its exploration for diamonds, subject to regulatory approval, the Company will grant Carnarvon 500,000 common shares. To-date, Diadem has expended approximately \$1,000,000.

There are no other options or share purchase warrants outstanding and as of the date of release of these financial statements, 41,866 shares were held in escrow.

## 6. INCOME TAXES

(a) At December 31, 2004, the Company has non-capital losses of \$5,376,319 that can be used to reduce future taxable income. These losses expire as follows:

2005	\$843,600	2006	\$719,311	2007	\$1,049,090
2008	\$931,601	2009	\$769,609	2010	\$562,629
2011	\$500,479				

(b) As at December 31, 2004 the tax effects of temporary timing differences that give rise to significant components of the future tax asset (liability) computed at current rates were as follows:

Future Tax Asset	
Non-capital loss carry forward	\$2,365,580
Share issue costs	<u>1,797</u>
	2,367,377
Less Valuation allowance	<u>2,367,377</u>

Tax benefit recognized	---
Future Tax Liability	
Mining interest	<u>(867,145)</u>
Future tax liability	<u>\$(867,145)</u>

(c) The Company's provision for current income taxes differ from the amounts computed by applying current rates to the loss for the year before taxes, as shown in the following table:

	2004	2003
Statutory rate applied to loss for the year before income taxes	\$290,442	\$3,080,000
Non-deductible items	(88,550)	(2,860,000)
Share issue cost	16,150	30,000
Tax benefit not recognized on current year's losses	<u>(218,042)</u>	<u>(250,000)</u>
	Nil	Nil

(d) Future income taxes as presented in the Balance Sheet, \$867,145 as at December 31 2004, result from exploration expenditures renounced to shareholders on the issue of flow-through shares. The future income tax balance was reduced in 2003 and 2004 due to the write down of mineral property expenditures. The applicable income taxes have been calculated by applying current rates to the amounts renounced to flow-through shareholders.

## 7. INTEREST RECEIVED AND PAID

During the year 2004 interest of \$109,417 was recorded of which \$23,997 was applicable to administration and \$85,420 to mineral properties. For the year 2003 the total was \$122,857 of which \$11,070 was applicable to administration and \$111,787 to mineral properties. No interest was received for either year.

## 8. COMPARATIVE 2003 OPERATIONS, REVISED AND REFILED

The financial statements for the year ended December 31, 2003 after distribution to shareholders were revised, and refiled. to reflect the following;

- an addition under the heading "Other Agreement" was made to Note 3 to cover the rental of the Company's head office.
- the write down in 2003 on mineral property was restated as an operating activity in the Statement of Cash Flow where it was previously presented as an investment activity
- the future income tax provision previously presented on the Balance Sheet as \$1,885,996 has been restated as \$953,701 to reflect the actual current rate of 44% of the amounts renounced to flow-through shareholders. and consequently the loss per share previously reported as \$0.211 for the year 2003 was restated as \$0.124.