

# **DARNLEY BAY RESOURCES LIMITED**

## **ANNUAL REPORT 2007**

**Darnley Bay Resources Limited's (DBR) main focus is exploration for base metals and diamonds in an area surrounding the Hamlet of Paulatuk, located along the shores of Darnley Bay, in the Inuvialuit Settlement Region, NWT, Canada - the site of the strongest isolated gravity anomaly in North America.**

Board of Directors: William P.G. Allen, L.L.M., John S. Dowsett, P.Eng.,  
George R. Kent, P.Eng., Leon F. La Prairie, P.Eng.,  
Patricia G. Mannard, B.A. (Hons.), Peter G. Telford, Ph.D.

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## Letter to Shareholders of Darnley Bay Resources Limited

May 14, 2008

It is with great pleasure that I am able to provide a summary of the significant progress in the activities of the Company towards the exploration and development of mineral deposits in the Paulatuk region of the Northwest Territories.

Prior to last year's AGM, we commenced a Strategic Review to move the base metal exploration project forward. Since then, we have completed a re-analysis of the gravity and magnetic anomaly using the currently available geophysical software, and undertook a comprehensive 3D modelling study. The work, carried out by Paterson, Grant & Watson Limited and Mira Geoscience Ltd., was instrumental in developing new geological concepts and related mineral deposit models for the source of the Darnley Bay Anomaly, and refining targets for ongoing exploration. As a result, a new exploration programme to intensify the gravity coverage, prioritize targets and undertake an extensive drilling campaign has been prepared.

Diamond exploration on the Parry Peninsula is ongoing, through our joint venture with Diadem Resources Ltd. A ground geophysical campaign has just been completed, and we are awaiting the results. They will be used to better define the geometry of the known kimberlite pipes, and to prioritize new targets for the planned drill programme.

The renewed exploration over the Darnley Bay Anomaly has required a new Concession Agreement with the landholders, the Inuvialuit. The Concession Agreement has been negotiated with the Inuvialuit Regional Corporation (IRC). It was ratified by the Inuvialuit beneficiaries in the community of Paulatuk on April 26, 2008. It will come into force upon payment of \$500,000 and negotiation of a payment schedule for the remaining debt to the IRC, incurred under the expired Concession Agreement. In the meantime, the Company has commenced the process of applying for the necessary land access permits to undertake exploration, and a Comprehensive Cooperation and Benefits Agreement with the IRC, to incorporate employment and commercial opportunities for the Inuvialuit and Inuvialuit owned or joint venture businesses. We must mention that the IRC have been quite proactive and cooperative in this regard, and want to prepare the communities for a sustainable mining industry within the Inuvialuit Settlement Region.

Another aspect of the Company's renewal is to invigorate the management of the Company. Immediately following the AGM, I will relinquish my duties as President and CEO to Stephen Reford, who will carry the Company forward through the new exploration programme. He is a geophysicist and professional engineer with 27 years of industry

experience, and has worked on the Darnley Bay Anomaly since 1994. I will maintain a guiding hand to the Company in my fulltime capacity as Chairman, and will continue to act in the best interests of the shareholders. William Allen has decided to stand down as a Director of the Company at the AGM. We thank Bill for his many years of service as a Director. Allen, Allen & Doucette will remain as the legal counsel for the Company. Stephen Reford and Don Yamkowy have been nominated to serve as Directors. Don is a well-known businessman and connoisseur of the Arctic, based in Yellowknife, NT.

This past year has been marked by significant progress for Darnley Bay Resources Limited. As a junior company focused on mineral exploration in one region, the raising of capital has proven to be a challenge. However, we have been able to move forward and several funding opportunities have opened in recent months. The upcoming year promises an increased level of activity and excitement, as we devote our efforts to exploration towards the ultimate objective, the development of a new mining camp in the Paulatuk area.

With Kind Regards and Best Wishes,

Leon La Prairie, President and CEO

April 30, 2008

Management's Discussion and Analysis for the year-ended December 31, 2007

## GENERAL

Darnley Bay Resources Limited was formed in 1993 to explore and develop an area of geophysical significance in the Northwest Territories of Canada. In partnership with the Inuvialuit Regional Corporation, base metal exploration fortuitously resulted in the discovery of diamonds and the area is now host to both metallic and non-metallic mineral deposit interests. The Company's objectives are to secure and maintain successful financing partnerships to continue exploration for both base metals and diamonds resulting in the development of a profitable mining camp.

## SELECTED ANNUAL INFORMATION

|                                     | 2007    | 2006    | 2005    |
|-------------------------------------|---------|---------|---------|
| Net loss (in thousands)             | 1,268   | 305     | 6,140   |
| Loss per common share               | 0.03    | 0.01    | 0.16    |
| Total assets (in thousands)         | 526     | 38      | 239     |
| Shareholders' equity (in thousands) | (1,373) | (2,402) | (2,238) |

## BALANCE SHEET AND OPERATIONS

At December 31, 2007, assets totaled \$526,565 compared to \$38,338 at the 2006 year-end.

This amount includes an increase in mineral property expense during the year of \$192,500 (nil in 2006). The Company has incurred a continuing evaluation cost of future involvement in the project. The current liability decreased to \$1,899,675 from \$2,440,678 at the 2006 year-end. The share capital increased to \$19,930,636 from \$18,147,232 in 2006 through the private placement of 4,994,309 common shares for \$835,100, the exercise of 3,305,770 options for \$449,750, a debt conversion for 93,750 shares valued at \$22,500, an agreement option grant of 500,000 shares for \$192,500 and the addition of the fair value of options granted of \$293,004. In 2006, there were 705,000 common shares issued through private placements for \$70,500 and 468,146 common shares issued through a debt conversion valued at \$70,222 resulting in an increase in capital stock of \$140,722. The share issue cost in 2007 was \$9,450 (nil in 2006). The existing stock options resulted in a year-end stock-based compensation expense of \$713,212 and \$199,030 in 2006. The Company reported a net loss at December 31, 2007 of \$1,268,356 compared to \$305,410 in 2006. The ongoing corporate and general expenses required to run a public company continue to be monitored closely.

## LIQUIDITY AND CAPITAL RESOURCES

The Company is an exploration and development company and has no revenue. At December 31, 2007, the Company had cash resources of \$217,372 compared to \$35,655 at the 2006 year-end. There were 8,300,079 shares issued for \$1,284,850 during the year and 705,000 shares issued for \$70,500 in 2006. The Company has a working capital deficit of \$1,565,611 compared to \$2,402,341 at year-end 2006 and an accumulated deficit of \$22,016,958 (\$20,748,602 at the 2006 year-end). The Company is actively working to reduce liabilities through ongoing negotiations with primary creditors. During the year, a \$22,500 debt was converted to shares (\$70,222 in 2006). Further debt settlement is planned where allowable. On April 15, 2008, an amount of \$330,000 was received through private placements of 825,000 common shares.

The Company's current funding objective is to support a base metal exploration program that will include a review of the available geological and geophysical data relating to the area of interest and to drill the intrusive, and potential sulphide deposit, at its shallowest point. To enable the Company to carry out its plan, additional funds are now being sought. The Company's ability to raise the capital resources to undertake this objective is dependent on the venture capital market, metal prices and the ongoing relationship with the Inuvialuit Regional Corporation (the "IRC") allowing access to the property for the purpose of base metal exploration. The Company is in partnership with Diadem Resources Ltd. to ensure the continuation of the diamond exploration program and the fulfillment of the obligations with the IRC.

## SUMMARY OF QUARTERLY RESULTS

| <i>For the quarter ended</i>                     | <i>Dec. 31</i><br><i>2007</i>     | <i>Sep. 30</i><br><i>2007</i>     | <i>Jun. 30</i><br><i>2007</i>     | <i>Mar. 31</i><br><i>2007</i>     |
|--|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
| Net loss (in thousands)                          | 1,268                             | 276                               | 126                               | 174                               |
| Loss per common share                            | 0.03                              | 0.01                              | 0.01                              | 0.01                              |
| Total assets (in thousands)                      | 526                               | 469                               | 621                               | 671                               |
| Shareholders' equity (deficiency) (in thousands) | (1,373)                           | (1,590)                           | (1,536)                           | (2,340)                           |
| <br><i>For the quarter ended</i>                 | <br><i>Dec. 31</i><br><i>2006</i> | <br><i>Sep. 30</i><br><i>2006</i> | <br><i>Jun. 30</i><br><i>2006</i> | <br><i>Mar. 31</i><br><i>2006</i> |
| Net loss (in thousands)                          | 305                               | 469                               | 229                               | 102                               |
| Loss per common share                            | 0.01                              | 0.01                              | 0.001                             | 0.001                             |
| Total assets (in thousands)                      | 38                                | 210                               | 159                               | 237                               |
| Shareholders' equity (in thousands)              | (2,402)                           | (2,487)                           | (2,466)                           | (2,340)                           |

## ANALYSIS OF MINERAL PROPERTY EXPENDITURES

|                                     | 2007           | 2006     |
|-------------------------------------|----------------|----------|
| Project management                  | -              | -        |
| Project consulting fees             | -              | -        |
| Property access and agreement costs | <u>192,500</u> | <u>-</u> |
|                                     | 192,500        | -        |

## ANALYSIS OF CORPORATE AND GENERAL EXPENSES

|  | 2007      | 2006         |
|--|-----------|--------------|
| Project evaluation and management services | 167,653   | 113,864      |
| Stock based compensation                   | 807,186   | -            |
| Accounting services                        | 44,125    | 49,120       |
| Premises rent                              | 75,807    | 46,307       |
| Audit fees                                 | 32,150    | 24,475       |
| Legal fees                                 | 65,076    | 97,731       |
| Office services & supplies                 | 39,798    | 32,158       |
| Administration services                    | 103,520   | 40,587       |
| Stock transfer/exchange fees               | 41,050    | 21,719       |
| Shareholder communication                  | 18,747    | 19,151       |
| Interest                                   | 7,476     | 53,533       |
| Miscellaneous                              | <u>-</u>  | <u>1,068</u> |
|  | 1,402,588 | 499,713      |

## COMMON SHARES ISSUED

Common shares issued at the year-end 2007 were 47,183,581 (38,289,752 at the year-end 2006). During the year, 4,560,672 shares were issued through private placements at \$0.15 per share, 250,000 at \$0.20 and 183,637 at \$0.55 (in 2006, there were 705,000 shares issued at \$0.10 per share). There was a debt conversion resulting in the further issue of 93,750 shares at \$0.24 (in 2006, 468,146 shares were issued at \$0.15 through the conversion of debt). In 2005 share purchase options were granted to directors, officers and consultants at an exercise price of \$0.13 (3,600,000) and \$0.10 (100,000) expiring on November 4, 2009 and in 2007, there were 1,580,000 options granted at \$0.25 expiring on March 20, 2009 and 300,000 expiring on May 31, 2009, 800,000 at \$0.35 expiring on June 12, 2009 and 300,000 at \$0.45 expiring on October 16, 2009 in accordance with the Company's Stock Option Plan (see note 6c of the interim financial statements). During the year, there were 2,830,770 options exercised at \$0.13, 100,000 at \$0.10, 220,000 at \$0.15 and 155,000 at \$0.25 (in 2006, there were 500,000 options forfeited by a former director of the Company, 220,000 options were granted at an exercise price of \$0.15 and 400,000 were granted at \$0.13 for a total at the year-end of 3,820,000). At the year-end there were 3,494,230 options granted at a weighted average price of \$0.25. The Company issued 500,000 shares to Carnarvon Capital Corporation on October 3, 2007 at \$0.385 per share when the Darnley Bay/Diadem diamond joint venture met a \$2 million exploration expenditure target. The Company has 41,866 shares in escrow. On April 15, 2008, an additional 825,000 units for one share and one share purchase warrant were purchased through unbrokered private placements at \$0.40 per unit. The warrants are exercisable for one year at \$1.00 per share and for a second year (up to April 15, 2010) for \$2.00 per

share.

## ACCOUNTING POLICIES

The Company's accounting methods are based upon Canadian Generally Accepted Accounting Principles (GAAP) applicable to resource issuers, which are applied on a consistent basis. These are outlined in full detail in note 2 of Company's audited financial statements for the year ended December 31, 2007.

The recovery of amounts capitalized as Mineral Property expenditures is dependent upon the discovery of economically recoverable ore reserves, the ability of the Company to obtain necessary financing to explore and develop potential ore reserves, future profitable production, or alternatively, upon the Company's ability to dispose of its interests on an advantageous basis. At the 2005 year end, the carrying value of the mineral exploration property was considered unrecoverable and written down to \$1 due to uncertainties in financing. In 2006 and 2007, the Company continued to retain an interest in its property and looks to future funding opportunities and ongoing exploration for both base metals and diamonds.

The Company uses the fair value method of accounting for all stock options awarded. Compensation expense is recognized based on the fair value of the option on the date of the grant and is expensed over the vesting period of the option (see note 6c of the 2007 year end statement)

## RELATED PARTY TRANSACTIONS

Technical and administrative support is received from directors and officers of the Company. In the absence of financial resources to pay for these services, the allowable issuance of common shares for debt is undertaken. During the year, amounts charged for management fees by La Prairie Ltd. (controlled by Leon La Prairie, CEO/director) were \$48,000 (\$48,000 in 2006). Mr. La Prairie charged \$77,000 for consulting services (2006 - \$63,500).

Accounting services were provided in the amount of \$25,500 during 2006 by the Company's former CFO, Richard La Prairie. La Prairie received 93,750 shares through debt conversion at \$0.24 per share, he received 468,146 shares through a debt conversion at \$0.15 per share in 2006. Additional shares or cash will be issued to eliminate a balance of \$72,276 owing to La Prairie.

William Allen, director, provided legal services to the Company during the year in the amount of \$65,076 (97,731 in 2006). Patricia Mannard provided corporate maintenance and accounting management services in the amount of \$44,125 (\$23,620 in 2006). John Dowsett, a director, provided geophysical and project development services in the amount of \$9,825 (\$13,175 in 2006). George Kent, a director, provided geological consulting services in the amount of \$5,821 (\$3,860 in 2006). As at December 31, 2007, accounts payable to the above total \$465,687 (2006 - \$753,502).

During the year, options were exercised by Leon La Prairie (1,000,000 at \$0.13), Allen (800,000 at \$0.13), Mannard (500,000 at \$0.13), Richard La Prairie (300,000 at \$0.13), Dowsett (230,770 at \$0.13) and Kent (100,000 at \$0.10). Leon La Prairie, CEO, was granted 1,000,000 options exercisable at \$0.25 up to March 20, 2009 and Mannard, was granted 500,000 options with the same terms. Peter Telford, a director appointed during the year, was granted 300,000 options at \$0.45 exercisable on or before October 16, 2009.

## COMMITMENTS

Note 4 of the financial statements for the year ended December 31, 2007 covers both the governing agreements with the Inuvialuit Land Corporation and the joint venture agreement with Diadem Resources Ltd. for exploration of diamonds.

Effective November 26, 2003 the Company entered into an agreement to form a joint venture with Diadem Resources Ltd., formerly an agreement held with Carnarvon Capital Corporation, to operate diamond exploration in an area near Paulatuk in the Northwest Territories. The earn in requirements and project area were amended on November 29, 2007 and Diadem has until June 30, 2008 to meet the new commitment to gain further participation rights. Diadem has not met earn in requirements outlined in the agreement at the time of this report.

The joint venture entered into a letter agreement with the Inuvialuit Regional Corporation allowing access to the property that lies within the Inuvialuit Settlement Region. The Company's joint venture partner has, at the time of this report, not confirmed that the conditions of the agreement have been met in full however; the Company has received confirmation of its good standing in a letter dated July 13, 2007.

## CORPORATE GOVERNANCE

On February 22, 2007, the Company filed its Corporate Governance Policy document with the TSX Venture Exchange and on [www.sedar.com](http://www.sedar.com).

## RISKS AND UNCERTAINTIES

The inherent risks, which most profoundly affect the Company's activities, are metal prices and the ability of the Company to obtain venture capital necessary to establish economic ore reserves. Further, the Company is relying on its joint venture partner to fulfill its obligations as operator of the diamond exploration project and the Inuvialuit Regional Corporation to allow property access for diamond and base-metal exploration.

## OUTLOOK

The ongoing strength in metal prices and the influx of major mining companies participating in diamond exploration in the area surrounding our interests in the Northwest Territories has bolstered financing possibilities. Renewed interest from the investment community and continuing support from the Inuvialuit Regional Corporation and other local participants is encouraging. The Company anticipates the commencement of diamond target drilling by its joint venture partner in 2008. A base metal exploration schedule is in place to further define the property's potential. The exploration program is contingent upon the receipt of funds through equity financing or joint ventures on terms most favourable for our shareholders and the finalization of a new base-metal concession agreement with the Inuvialuit Regional Corporation.

This MD&A contains certain forward-looking statements related but not limited to the Company's operations, anticipated financial performance, business prospects and strategies. Forward-looking information typically contains statements with words such as "anticipate", "believe", "expect", "plan" or similar words suggesting future outcomes. Readers are cautioned to not place undue reliance on forward-looking information because it is possible that the Company will not achieve predictions, forecasts, projections and other forms of forward-looking information.

THE MANAGEMENT'S DISCUSSION AND ANALYSIS SHOULD BE READ IN CONJUNCTION WITH THE COMPANY'S AUDITED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006 WHICH ACCOMPANY THIS ANALYSIS AND, ALTERNATELY ARE AVAILABLE ALONG WITH ALL THE COMPANY'S PUBLIC DOCUMENTS ON [WWW.SEDAR.COM](http://WWW.SEDAR.COM)

DARNLEY BAY RESOURCES LIMITED

(A Development Stage Company)

FINANCIAL STATEMENTS

DECEMBER 31, 2007 and 2006

DARNLEY BAY RESOURCES LIMITED

(A Development Stage Company)

FINANCIAL STATEMENTS

DECEMBER 31, 2007 and 2006

I N D E X

|                                | PAGE   |
|--------------------------------|--------|
| AUDITORS' REPORT               | 1      |
| BALANCE SHEETS                 | 2      |
| STATEMENTS OF LOSS AND DEFICIT | 3      |
| STATEMENTS OF CASH FLOWS       | 4      |
| NOTES TO FINANCIAL STATEMENTS  | 5 - 15 |



AUDITORS' REPORT

To the Shareholders of  
Darnley Bay Resources Limited:  
(A Development Stage Company)

We have audited the balance sheets of Darnley Bay Resources Limited (The "Company", A Development Stage Company) as at December 31, 2007 and 2006 and the statements of 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. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

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

(Signed) "Edmund Cachia & Co."

Toronto, April 30, 2008

CHARTERED ACCOUNTANTS  
Licensed Public Accountants

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

BALANCE SHEETS

DECEMBER 31

|                                 | ASSETS            |                  |
|---------------------------------|-------------------|------------------|
| CURRENT                         | 2007              | 2006             |
| Cash                            | \$ 217,372        | \$ 35,655        |
| Accounts receivable             | <u>116,692</u>    | <u>2,682</u>     |
|                                 | 334,064           | 38,337           |
| MINERAL PROPERTY (note 1 and 3) | <u>192,501</u>    | <u>1</u>         |
|                                 | <u>\$ 526,565</u> | <u>\$ 38,338</u> |

LIABILITIES

|   |              |              |
|---|--------------|--------------|
| CURRENT   |              |              |
| Accounts payable and accrued liabilities (note 5) | \$ 1,899,675 | \$ 2,440,678 |

SHAREHOLDERS' DEFICENCY

|                              |                       |                       |
|------------------------------|-----------------------|-----------------------|
| CAPITAL STOCK (notes 6(b))   | 19,930,636            | 18,147,232            |
| CONTRIBUTED SURPLUS (note 8) | 713,212               | 199,030               |
| DEFICIT                      | ( <u>22,016,958</u> ) | ( <u>20,748,602</u> ) |
|                              | ( <u>1,373,110</u> )  | ( <u>2,402,340</u> )  |
|                              | <u>\$ 526,565</u>     | <u>\$ 38,338</u>      |
| Subsequent events (note 11)  |                       |                       |
| Going concern basis (note 1) |                       |                       |

Approved by the Board:

(Signed) "Leon La Prairie" \_\_\_\_\_, Director  
(Signed) "Patricia Mannard" \_\_\_\_\_, Director

The accompanying notes are an integral part of the financial statements.  
DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

## STATEMENTS OF LOSS AND DEFICIT

FOR THE YEAR ENDED DECEMBER 31

|  | 2007                     | 2006                     |
|--|--------------------------|--------------------------|
| EXPENSES   |                          |                          |
| Office administration services                       | \$ 185,378               | \$ 121,865               |
| Project evaluation costs (note 3)                    | 167,653                  | 113,864                  |
| Professional fees                                    | 97,226                   | 122,206                  |
| Premises rent  | 75,807                   | 46,307                   |
| Shareholder communication                            | 61,862                   | 40,870                   |
| Stock option compensation cost                       | 807,186                  | -                        |
| Interest   | 7,476                    | 53,533                   |
| Other general  | <u>-</u>                 | <u>1,068</u>             |
| Loss before the under noted                          | ( 1,402,588)             | ( 499,713)               |
| Write down of payables                               | <u>134,232</u>           | <u>194,303</u>           |
| NET LOSS FOR THE YEAR                                | ( 1,268,356)             | ( 305,410)               |
| DEFICIT AT BEGINNING OF THE YEAR                     | ( <u>20,748,602</u> )    | ( <u>20,443,192</u> )    |
| DEFICIT AT END OF THE YEAR                           | ( <u>\$ 22,016,958</u> ) | ( <u>\$ 20,748,602</u> ) |
| Basic and diluted loss per share (note 2)            | <u>\$ 0.03</u>           | <u>\$ 0.01</u>           |
| Weighted average number of common shares outstanding | <u>44,790,604</u>        | <u>37,594,897</u>        |

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

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

STATEMENTS OF CASH FLOWS

FOR THE YEAR ENDED DECEMBER 31

|   | 2007              | 2006             |
|---|-------------------|------------------|
| CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES:                |                   |                  |
| Net loss for the year   | (\$ 1,268,356)    | (\$ 305,410)     |
| Non-cash items:   |                   |                  |
| Decrease in deposits  | -                 | 233,468          |
| Stock option cost   | 807,186           | -                |
| Write down of payables  | 134,232           | 194,303          |
| Net changes in working capital balances:                        |                   |                  |
| Increase in accounts receivable                                 | ( 114,010)        | ( 696)           |
| Increase (decrease) in accounts payable and accrued liabilities | ( 652,736)        | ( 160,318)       |
| Cash used in operations   | ( 1,093,684)      | ( 38,653)        |
| CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES:                |                   |                  |
| Issue of common shares  | 1,284,851         | 70,500           |
| Share issue cost  | ( 9,450)          | -                |
| Cash provided by financing                                      | 1,275,401         | 70,500           |
| INCREASE IN CASH POSITION                                       | 181,717           | 31,847           |
| CASH POSITION AT BEGINNING OF THE YEAR                          | 35,655            | 3,808            |
| CASH POSITION AT END OF THE YEAR                                | <u>\$ 217,372</u> | <u>\$ 35,655</u> |
| Supplementary disclosure of non-cash items                      |                   |                  |
| Shares issued for non-cash consideration:                       |                   |                  |
| Issuance of common shares for mineral interests                 | \$ 192,500        | \$ -             |
| Issuance of common shares for debt                              | \$ 22,500         | \$ 70,222        |

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

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

1 - NATURE OF OPERATIONS AND GOING CONCERN CONSIDERATIONS:

The Company is in the business of exploring for base metals and diamonds in the Northwest Territories, Canada. To date, the Company has not earned significant revenues and still is considered to be in the development stage. The Company's shares are listed on the TSX Venture Exchange.

The recovery of amounts capitalized as Mineral Property Costs is dependent upon the discovery of economically recoverable ore reserves, the ability of the Company to obtain necessary financing to explore and develop potential ore reserves, future profitable production, or alternatively, upon the Company's ability to dispose of its interests on an advantageous basis. At the 2005 year end, the carrying value of the mineral exploration property was considered unrecoverable and written down to \$1 due to uncertainties in financing. The Company continues to retain interest in its property and looks to future funding opportunities and ongoing exploration for both base metals and diamonds.

As at December 31, 2007, the Company has a working capital deficiency of \$1,565,611 (2006 - \$2,402,341). Management is currently pursuing several financing alternatives to raise capital. It is not possible to determine with any certainty, the success or adequacy of these initiatives. The Company could possibly be considered to be in arrears in meeting some property access commitments (see note 4). However, in order for the property grantor to exercise default mechanisms, the access grantor must issue a default notice in writing, the date from which the Company has six months to satisfy the commitments that are in arrears.

The financial statements of the Company have been prepared on the basis that the Company will continue as a going concern, which presumes that it will be able to realize its assets and discharge its liabilities in the normal course of business. The financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

2 - SIGNIFICANT ACCOUNTING POLICIES:

MINERAL PROPERTY AND RELATED EXPENDITURES

Mineral Property and Related Expenditures consist of costs of acquiring mineral rights 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.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

2 - SIGNIFICANT ACCOUNTING POLICIES (continued):

MINERAL PROPERTY AND RELATED EXPENDITURES (continued)

The Company reviews its exploration properties to determine if events or changes in circumstances have transpired which indicate that the carrying value of its assets may not be recoverable. The recoverability of costs incurred on the exploration properties is dependant upon numerous factors including exploration results, environmental risks, community risks, political risks, and the Company's ability to attain profitable production. An impairment loss is recognized when the carrying amount of the exploration properties is not recoverable and exceeds its fair value. It is possible, based on existing knowledge, that changes in future conditions in the near-term could require a change in the determination of the need for and amount of any write-down.

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 tax assets also arise from unused tax 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 and is reviewed annually and adjusted, if necessary, by use of a valuation allowance.

LOSS PER SHARE

Basic loss per share is computed by using the weighted average number of common shares outstanding during the year. Diluted loss per share is calculated giving effect to the potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted to common shares using the treasury stock method. The treasury stock method assumes that proceeds received from the exercise of stock options and warrants are used to redeem common shares at the prevailing market value.

STOCK OPTION COMPENSATION

The Company has a stock option plan, which is described in note 6c). The Company accounts for stock-based compensation using the fair-value method. Under the fair-value method, stock-based payments are measured at the fair value of equity instruments and are amortized over the vesting period. The offset to the recorded cost is contributed surplus in shareholder's equity.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

2 - SIGNIFICANT ACCOUNTING POLICIES (continued):

ESTIMATES

The financial statements of the Company have been prepared in accordance with generally accepted accounting principles of Canada. Precise determination of amounts of some assets and liabilities is dependent on future events. This requires that management make estimates in the preparation of financial statements. Actual results could vary from the estimates.

ASSET RETIREMENT OBLIGATIONS

The Company recognizes fair value of a future asset retirement obligation as a liability in the year in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The Company concurrently recognizes a corresponding increase in the carrying amount of the related long-lived asset that is depreciated over the life of the asset. The fair value of the asset retirement obligation is estimated using the expected cash flow approach that reflects a range of possible outcomes discounted at a credit-adjusted risk-free interest rate. Subsequent to the initial measurement, the asset retirement obligation is adjusted at the end of each year to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. Changes in the obligation due to the passage of time are recognized in income as an operating expense using the interest method. Changes in the obligation due to changes in estimated cash flows are recognized as an adjustment of the carrying amount of the long-lived asset that is depreciated over the remaining life of the asset. At December 31, 2007, the Company has not incurred or committed any asset retirement obligations relating to its exploration properties.

IMPAIRMENT OF LONG-LIVED ASSETS

Long-lived assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

NEW ACCOUNTING PRONOUNCEMENTS

Comprehensive income and equity

Effective October 1, 2006, the Company adopted the new recommendations of CICA Handbook Section 1530, "Comprehensive Income" and Section 3251, "Equity". These sections establish standards for reporting and presenting certain gains and losses normally not included in net earnings or losses, such as unrealized gains and losses related to available-for-sale investments in a statement of comprehensive income. There was no impact on the financial statements in the current year.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

3 - MINERAL PROPERTY:

|   | Cumulative<br>to December<br>31, 2005 | 2006<br>Additions | Cumulative to<br>December 31,<br>2006 | 2007<br>Additions | Cumulative to<br>December 31,<br>2007 |
|---|---------------------------------------|-------------------|---------------------------------------|-------------------|---------------------------------------|
| Project management                          | 1,240,130                             | -                 | -                                     | -                 | -                                     |
| Consultants                                 | 2,275,056                             | -                 | -                                     | -                 | -                                     |
| Licenses and permits                        | 3,841,146                             | -                 | -                                     | -                 | -                                     |
| Property access and expense                 | <u>5,815,129</u>                      | <u>-</u>          | <u>-</u>                              | <u>192,500</u>    | <u>192,500</u>                        |
| Total expenditure for the period            | \$13,171,461                          | \$ -              | \$ -                                  | \$ 192,500        | \$ 192,500                            |
| Adjustment to prior years                   | (7,631)                               | -                 | -                                     | -                 | -                                     |
| Write down prior years                      | (6,696,718)                           | -                 | -                                     | -                 | -                                     |
| Write down current year                     | <u>(6,467,111)</u>                    | <u>-</u>          | <u>-</u>                              | <u>-</u>          | <u>-</u>                              |
| Balance, beginning of period                | <u>-</u>                              | <u>1</u>          | <u>1</u>                              | <u>1</u>          | <u>1</u>                              |
| Balance, end of period<br>(Also see note 1) | <u>\$ 1</u>                           | <u>\$ 1</u>       | <u>\$ 1</u>                           | <u>\$ 192,501</u> | <u>\$ 192,501</u>                     |

4 - AGREEMENTS:

JOINT VENTURE AGREEMENT WITH DIADEM RESOURCES LTD ("DIADEM")

Under an agreement (originally, June 24, 2003) with Carnarvon Capital Corporation ("Carnarvon") and Diadem Resources Limited ("Diadem") the Company agreed to a joint venture diamond exploration program in a corridor near Paulatuk in the Inuvialuit Settlement Region ("Inuvialuit") in the Northwest Territories. The principal terms, as amended from time to time, are as follows:

On November 29, 2007, Diadem agreed to raise and spend funds to explore for diamonds in the area north of 69 degrees 25 minutes latitude. The earn-in amount now includes an additional \$1,000,000 for the extended period from September 1, 2007 to June 30, 2008 (previously December 31, 2007) and further to the approximately \$3.2 million that has been reported as expended by Diadem commencing with the 2005 calendar year.

When the funds are spent, Diadem will have earned a 50% participating interest in the selected lands, with the Company holding the other 50%. Under the amended agreement, once Diadem has earned

its interest, it will advance \$1 million toward the continuing joint venture on behalf of the Company that may be repaid, without interest, out of the Company's share of production from a diamond mine. The interests of Diadem and the Company will be subject to such equity rights as may be held by the Inuvialuit, and by such third parties as they may retain if land is acquired from third parties. If there is a decision to carry out a feasibility study on the lands selected by Diadem, it will have the right to fund the feasibility study, and if the property is placed into commercial production Diadem's interest will increase to 75% and the Company's interest will decrease to 25%.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

4 - AGREEMENTS:

JOINT VENTURE AGREEMENT WITH DIADEM RESOURCES LTD ("DIADEM") (continued)

As outlined in the agreement, Carnarvon was issued 500,000 shares of the Company on October 3, 2007 after Diadem's first \$2 million in exploration expenditures.

AGREEMENTS WITH THE INUVIALUIT LAND CORPORATION ("INUVIALUIT")

On February 4, 2004, the Company/Diadem joint venture entered into an agreement with the Inuvialuit under which the Company/Diadem joint venture will enter into a Cooperation and Benefits Agreement with the Inuvialuit. The principal terms are as follows:

The 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 Company/Diadem 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 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 September 30, 2005. All costs to be expended under the terms of the agreement have been committed to be expended by Diadem under the terms of the Joint Venture Agreement. On April 23, 2007, the Company paid \$100,000 to the Inuvialuit on behalf of Diadem. Repayment terms are outlined in the revised joint venture agreement of November 29, 2007.

On July 13, 2007, the Inuvialuit confirmed that the Company remained in good standing with respect to the agreement.

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 and can obtain a 15 year deferral of Crown royalties. If the Inuvialuit do so, 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.

Although the Company intends on pursuing further work programs on the properties in accordance with the above agreements, due to uncertainty regarding the Company meeting its mineral property commitments, the Company wrote down its investment in the mineral properties during fiscal 2005.

During 2007, the Company incurred a continuing evaluation cost of future involvement in the project.

On May 8, 2007, the Company announced an agreement in principal with the Inuvialuit (subject to the ratification by the members of the Paulatuk Community Corporation) regarding the terms of a new base-metals/diamond concession in the 7(1)(a) lands where the Inuvialuit own the subsurface and surface rights. The agreement includes a two year payment schedule for the liability of approximately \$1,000,000 owed to the Inuvialuit. The new concession follows the terms of the Company's prior

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

4 - AGREEMENTS:

AGREEMENTS WITH THE INUVIALUIT LAND CORPORATION ("INUVIALUIT") (continued)

2001 mineral/diamond agreement, with minimum exploration expenditure of \$6 million for the first three years and \$7 million for the following seven years of the Exploration Phase plus \$1 million for each renewal year.

5 - RELATED PARTY TRANSACTIONS:

During the year, a company controlled by the Chief Executive Officer and director of the Company, charged \$48,000 (\$48,000 in 2006) for management fees, \$74,525 for rent (\$44,853 in 2006) and \$9,039 for offices services (\$5,302 in 2006). In 2006, the Company was issued 605,000 shares through a private placement. Project evaluation cost fees in the amount of \$77,000 (2006 - \$63,500) were charged by the CEO and director directly plus reimbursable office and meeting expenses of \$10,175 (\$2,122 in 2006). In 2006, the individual subscribed for 100,000 shares through a private placement.

Accounting services provided to April 30, 2006, in the amount of \$25,500, were provided by the former Chief Financial Officer of the Company. The former CFO received 93,750 shares (468,146 in 2006) through a debt conversion at \$0.24 per share (\$0.15 in 2006) (note 6b).

Legal fees amounting to \$65,076 (2006 - \$97,731) were charged by a law firm of which a director of the Company is a partner.

Corporate maintenance and accounting management fees amounting to \$44,125 (2006 - \$23,620) were charged by a director and officer of the Company.

Consulting fees amounting to \$15,646 (2006 - \$17,035) were charged by directors of the Company.

In 2007, there were 1,500,000 options granted to directors (400,000 in 2006).

As at December 31, 2007, accounts payable include \$465,687 (2006 - \$753,502) payable to the

related parties mentioned above.

Management believes these transactions are in the normal course of business and are measured at the exchange amount, which is the amount of consideration established and agreed to by the parties.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

6 - CAPITAL STOCK:

a) Authorized:

An unlimited number of common shares

b) Common shares issued:

|  | 2007       |               | 2006       |               |
|--|------------|---------------|------------|---------------|
|  | Shares     | Amount        | Shares     | Amount        |
| Balance, beginning of the year           | 38,289,752 | \$ 18,147,232 | 37,116,606 | \$ 18,006,510 |
| Issued for cash (note 4)                 | 4,994,309  | 835,100       | 705,000    | 70,500        |
| Issued for cash / on exercise of options | 3,305,770  | 449,750       | -          | -             |
| Issued under agreement option (note 3)   | 500,000    | 192,500       | -          | -             |
| Issued for debt conversion (note 4)      | 93,750     | 22,500        | 468,146    | 70,222        |
| Fair value of options exercised          | -          | 293,004       | -          | -             |
| Share issue cost                         |            | (9,450)       |            | -             |
|  |            |               |            |               |
| Balance, end of the year                 | 47,183,581 | \$19,930,636  | 38,289,752 | \$18,147,232  |

See note 11 for additional capital stock information.

c) Stock option plan

Under the Company's Incentive Stock Option Plan (the plan), the Company has granted options to its directors, officers and consultants, to purchase up to a total of 3,494,230 shares. The exercise price of the options is \$0.13 for 669,230 (expiring on November 4, 2009), \$0.25 for 1,500,000 and 225,000 (expiring on March 20, 2009 and May 31, 2009), \$0.35 for 800,000 (expiring on June 12, 2009) and \$0.45 for 300,000 (expiring on October 16, 2009). The Company maintains the plan for the benefit of directors, officers, consultants and other services providers 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 total number of common shares that may be reserved for issuance may not exceed 10% of outstanding common shares and may not exceed 5% for any one person. The exercise price of an option may not be lower than the discounted market price of the common shares on the TSX Venture Exchange. The options are non-transferable. Outstanding options may be adjusted by the Board in certain events, as to exercise price and number of common shares, to prevent dilution or enlargement. At the year end, the Company has reserved 4,718,358 common shares to be granted under the plan.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

6 - CAPITAL STOCK (continued):

c) Stock option plan (continued)

The following summarizes the director and consultant stock options that have been granted, exercised or forfeited during the years ended 2007 and 2006. The forfeited options were those of an optionee who ceased to be a director, officer or consultant to the Company in the period.

Options granted:

| Common share options       | Number      | Weighted<br>average Price |
|----------------------------|-------------|---------------------------|
| Balance December 31, 2005  | 3,700,000   | \$ 0.13                   |
| Granted                    | 620,000     | -                         |
| Forfeited                  | (500,000)   | -                         |
| Exercised                  | -           | -                         |
| Balance December 31, 2006  | 3,820,000   | \$ 0.13                   |
| Granted                    | 2,980,000   | 0.30                      |
| Forfeited                  | -           | -                         |
| Exercised                  | (3,305,770) | 0.13                      |
| Balance, December 31, 2007 | 3,494,230   | \$ 0.25                   |

The fair value of each option was estimated on the date of grant. Under Black-Scholes the options issued during the year ended December 31, 2007 have been valued at \$807,186, and expensed to loss, using the following assumptions at the measurement date:

|                         | 2007         | 2006 |
|-------------------------|--------------|------|
| Risk-free interest rate | 3.79 - 4.74% | nil  |
| Expected life           | 2 -5 years   | nil  |
| Price volatility        | 100%         | nil  |
| Dividend yield          | nil          | nil  |

See note 11 for additional stock option information.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

7 - INCOME TAXES:

- a) At December 31, 2007, the Company has non-capital losses of \$4,748,439 that can be used to reduce future taxable income. These losses expire as follow:

|      |                     |
|------|---------------------|
| 2008 | \$ 1,059,842        |
| 2009 | 941,564             |
| 2010 | 809,149             |
| 2011 | 559,902             |
| 2015 | 494,417             |
| 2016 | 328,238             |
| 2017 | 300,310             |
| 2027 | <u>291,017</u>      |
|      | <u>\$ 4,784,439</u> |

As at December 31, 2007 the tax effects of temporary timing differences that give rise to significant components of the future tax asset computed at current rates, were as follows:

|                                  |                     |
|----------------------------------|---------------------|
| Non-capital losses carry forward | \$ 1,728,139        |
| Capital assets                   | 11,103              |
| Mining interests                 | 1,725,757           |
| Less: Valuation allowance        | <u>( 3,464,999)</u> |
| Net asset                        | <u>\$ -</u>         |

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

|   | 2007         | 2006         |
|---|--------------|--------------|
| Statutory rate applied to loss for the year before income taxes | (\$ 458,130) | (\$ 109,948) |
| Increase in taxes resulting from:                               |              |              |
| Non-deductible stock-based compensation                         | 291,556      | -            |
| Other items   | 903          | 1,836        |
| Project evaluation costs  | 60,556       | 41,128       |

|                              |                |               |
|------------------------------|----------------|---------------|
| Tax loss not benefited       | <u>105,115</u> | <u>66,984</u> |
| Future income tax (recovery) | <u>\$ -</u>    | <u>\$ -</u>   |

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

8- CONTRIBUTED SURPLUS:

Contributed surplus is comprised of the following:

|                                | 2007              | 2006              |
|--------------------------------|-------------------|-------------------|
| Balance, beginning of the year | \$ 199,030        | \$ 199,030        |
| Stock-based compensation cost  | 807,186           | -                 |
| Exercise of stock options      | <u>( 293,004)</u> | <u>-</u>          |
| Balance, end of the year       | <u>\$ 713,212</u> | <u>\$ 199,030</u> |

9 - FINANCIAL INSTRUMENTS:

a) Fair value

The Company has determined the estimated fair value of its financial instruments based on estimates and assumptions. The actual results may differ from those estimates and the use of different assumptions or methodologies may have a material effect on the estimated fair value amounts.

The fair value of cash, accounts receivable and accounts payable and accrued liabilities are comparable to their carrying value due to the relatively short period to maturity of these instruments.

b) Credit risk

The Company does not have any material risk exposure to any single debtor or group of debtors.

c) Commodity price risk

The ability of the Company to develop its properties and the future profitability of the Company is directly related to the market price of certain minerals.

10 - COMPARATIVE FIGURES:

Certain comparative figures have been reclassified to conform to the current year's presentation. These reclassifications did not affect prior year's net losses.

11 - COMMITMENTS AND SUBSEQUENT EVENTS:

- a) On February 2, 2007, the Company entered a non-exclusive agency agreement to raise funds in the form of private placements of equity. As compensation, the agent is entitled to a ten percent commission as well as broker's warrants. This agreement has a twelve-month term.
- b) On February 6, 2007, the Company entered into a five-year finders fee agreement. Under the terms of this agreement, DBR will pay the finder ten percent of amounts up to \$10 million and six percent of any additional funds raised through introductions to potential investors.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

11 - COMMITMENTS AND SUBSEQUENT EVENTS (continued):

- c) On February 7, 2007, the Company entered into a finder's fee agreement with an individual. The Company has agreed to pay ten percent, in cash, of any amounts paid by qualified investors introduced to the Company by the finder.
- d) On March 8, 2007, there were 2,930,770 common shares issued through the exercise of options at \$0.13 and \$0.10. An amount of \$378,000 was received. In addition, on March 30, 2007, 1,580,000 options were granted to directors and a consultant at an exercise price of \$0.25 and are exercisable for a two year period.
- e) On April 15, 2008, the Company entered into private placements of 825,000 units entitling the holders to one common share and one share purchase warrant for a price of \$0.40 per unit. The warrant holders may purchase one additional share for \$1.00 in the first year and \$2.00 in the second year ending on April 14, 2009. The gross proceeds received were \$330,000.