

**DARNLEY BAY RESOURCES LIMITED**

**ANNUAL REPORT 2010**

**Darnley Bay Resources Limited's 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: Mark Bennett, Kerry Knoll, Leon F. La Prairie,  
Patricia G. Mannard, Stephen Reford, James Richardson,  
Peter G. Telford and Donald Yamkowy

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## Letter to Shareholders of Darnley Bay Resources Limited

May 30, 2011

Darnley Bay Resources Limited made significant progress in the last year. A drill turned on its base metals and diamond projects for the first time since 2001. A \$4.25 million dollar financing in August 2010, led by Haywood Securities Inc., provided funds to extend the drilling program for base metals.

The airborne geophysical surveys completed in spring 2010 were interpreted and utilized to prioritize a number of new gravity, magnetic and electromagnetic targets on the base metals project. An August to November campaign of ground geophysics, geological prospecting and drilling was undertaken. The geophysics proved up and refined all of the gravity targets that were surveyed. Prospecting was limited to the canyons where bedrock (mainly sediments) is exposed. Three base metal targets were drilled at widely separate locations across the property. All proved difficult to drill to their target depths due to the nature of the overlying sediments, composed of approximately 250 m of glacial tills, unconsolidated sediments and vuggy dolomites. These sediments in permafrost were unstable, with shifting of the casing and infill of sand and clay that resulted in each hole being lost. One hole was drilled again in March 2011 but suffered the same fate, despite improvements to the drilling equipment, supplies and approach. The Company is currently seeking a reverse circulation drill and contractor with the sufficient technology and Arctic experience to case holes through the sediments prior to continuing to the targets with a diamond drill.

In July 2010, the Company committed to a joint venture with Diadem Resources Ltd. that will result in a 50/50 diamond exploration partnership on the Parry Peninsula. Diadem financed a program of ground magnetic surveys and five drillholes in August. Of the four targets drilled, three resulted in the discovery of new kimberlite pipes, bringing the total to thirteen on the Parry Peninsula. Analysis of the core resulted in encouraging indicator mineral results and three microdiamonds from one pipe. Seven kimberlite pipes have now proven diamondiferous. More than twenty kimberlite pipe targets remains to be drilled on the Parry Peninsula claims. Diadem is currently seeking funds to carry out an expanded drill program in 2011.

A successful mining venture requires the cooperation and involvement of the local communities. We have achieved a strong working relationship with the Inuvialuit, and the community of Paulatuk that is located within the Darnley Bay Anomaly. The Company worked with the Paulatuk Development Corporation, Inuvialuit Regional Corporation, CanNor (federal government) and the territorial government to facilitate the purchase and operation of an exploration field camp by the Inuvialuit in Paulatuk. The company contracted a number of workers and Paulatuk-based contractors to participate in the 2010 and 2011 programs, and provided training as well. In addition, a number of Inuvialuit businesses and partnerships from Inuvik and elsewhere provided services to the project.

We are pleased that a new Director joined our Board in 2010. James (Jay) Richardson has been involved extensively in the mining and other industries at the CFO and CEO levels, and has proven to be an invaluable addition.

Although we were disappointed that the drilling program in 2010-11 did not determine the source of the Darnley Bay anomaly, we are confident that a reverse circulation drill and other new drilling techniques will achieve our objectives. We are now pursuing additional financing, new technical personnel and contractors for the next drill program. In addition, the Company is preparing a 43-101 report on the base metals project.

Stephen Reford, President and CEO

May 2, 2011

**DARNLEY BAY RESOURCES LIMITED** - Management's Discussion and Analysis  
For the year ended December 31, 2010

GENERAL

Darnley Bay Resources Limited was formed in 1993 to explore for and develop base metal deposits related to the 50 km x 80 km, 132 mGal Darnley Bay gravity anomaly near Paulatuk, Northwest Territories, Canada. The source of the anomaly remains unexplained. Darnley Bay is currently exploring and drilling for base metals on its 4,600 km<sup>2</sup> land holding. It has a partnership with Diadem Resources Ltd. on 33 claims where 13 kimberlite pipes have been discovered to date, of which 7 have proven diamondiferous. The Company is committed to pursue equity financing and seek joint venture partnerships to enable the current exploration and development program to continue.

EXPLORATION ACTIVITIES AND OUTLOOK

During the year, the Company commenced field and drill activities to locate deposits of metals and diamonds in the Paulatuk, Northwest Territories area. Analysis and modeling of the geophysical and geological data led the Company to seek additional financing so that it could significantly expand its base metals drill program in the third quarter. The ongoing support from the Inuvialuit Regional Corporation (IRC), the community of Paulatuk and other local participants is encouraging.

The Company is focused on two project areas near Paulatuk, Northwest Territories. It holds 100% of the rights to the mineral concession covering all of the Paulatuk 7(1)(a) lands, and 100%-owned prospecting permits adjacent to the concession in 7(1)(b) lands and Crown lands. The concession and prospecting permits cover an area of 4,557 km<sup>2</sup>, and host base metals and diamond targets. In addition, the Company and Diadem Resources Ltd. jointly hold 33 claims on the Parry Peninsula northeast of Paulatuk, where the focus is diamond exploration. The land classifications in the Paulatuk area are as follows:

- Inuvialuit 7(1)(a) lands – The Inuvialuit hold the mineral and surface rights.
- Inuvialuit 7(1)(b) lands – The Inuvialuit hold the surface rights and the Crown holds the mineral rights.
- Crown lands – The Crown holds the mineral and surface rights.

Through a new partnership agreement with Diadem Resources Ltd. announced on July 9, 2010, the Company began a kimberlite pipe drill program in the third quarter and continued field work into the fourth quarter.

Some of the highlights from the year ended December 31, 2010 include:

- Ground gravity, magnetic and electromagnetic surveys over base metals targets were carried out in the August to October 2010 period. Geological mapping occurred during the same period.
- Drilling of base metals targets commenced on August 28, 2010 and continued to November 20, 2010. Three targets were drilled at widely separate locations, totaling 878 m. Drilling proved challenging, with glacial overburden and unconsolidated sediments in excess of 150 m encountered at each target. An underlying unit of vuggy dolomite compounded the drilling difficulties. The early onset of unusual winter weather reduced production as the season wore on. Two of the three holes penetrated the overburden and reached sedimentary bedrock. Neither explained the geophysical targets and warrant further drilling.
- Numerous Inuvialuit residents of Paulatuk were hired as employees and trainees for exploration and camp positions. The Paulatuk Hunters and Trappers Committee and the Inuvialuit Land Administration were contracted to provide wildlife and environmental monitors respectively. Services provided by Inuvialuit companies and partnerships include provision of helicopters, air transport, logistics and land surveying.
- Diadem Resources Ltd. notified the Company on November 12, 2010 that it intended to exercise its option for diamond exploration and production on ten prospecting permits (2,040 km<sup>2</sup>) currently held by the Company south and southwest of Paulatuk, where the two companies previously explored for diamonds, upon payment of certain fees and expenditures to the Company. As a result, the two companies plan to form a 50/50 joint venture for the area.
- On September 17, 2010, the Company paid its debt installment of \$327,249 to the Inuvialuit Land Corporation, more than three months prior to its due date. This reduces the interest costs for the final debt installment due December 21, 2011.

Subsequent to the year-end, the Company reports the following activities:

- Commencing late in the fourth quarter of 2010 and continuing through the first quarter of 2011, the Company reviewed the 2010 drill program and undertook measures to improve the drilling approach in 2011. An independent review of the current drill program was carried out by Jacquelin Gauthier, P. Eng., Geo. After visits to Yellowknife and Toronto, Mr. Gauthier made a series of recommendations to optimize the program and implement cost efficiencies. He will continue to act as an advisor to the Company.
- A drill crew and support personnel were mobilized to its base metals property on March 22, 2011. It commenced drilling target G-09-01A on March 30 and reached a depth of 242 meters, with the transition from semi-consolidated clay to vuggy dolomite occurring at 157 meters. Voids in excess of 3 meters and infiltration of sand and clay prevented further drilling. The thick and loose nature

of the cover material overlying difficult bedrock is proving to be a challenge for drilling, despite the new measures taken that proved more efficient than in 2010. The Company is reviewing its strategies with external consultants and is considering a number of options to move the base metals program forward. It is highly likely that a reverse circulation drill will be required to case its drillholes to stable bedrock at depths on the order of 250-300 m, and then continuing the holes with a diamond drill to the target depths.

- A reflection seismic survey was considered to assess overburden conditions prior to drilling, but was deferred due to cost and logistical reasons. Seismic may be incorporated in future drill programs.
- An assessment report was filed for the airborne geophysical surveys flown over the Company's prospecting permits in spring 2010. It is anticipated that Indian & Northern Affairs Canada will refund deposits to the Company, paid to acquire the prospecting permits.
- Throughout 2010 and early 2011, the Company worked with officials of the Government of Canada (Canadian Northern Economic Development Agency), the Northwest Territories Government (Industry, Tourism & Investment), the Inuvialuit Regional Corporation (IRC) and the Paulatuk Development Corporation (PDC) to purchase an exploration camp for operation by the PDC. As a result, PDC received grants of \$485,000 and \$25,000 from the federal and territorial governments respectively, of which \$330,098 was allocated for the camp purchase and transport to Paulatuk. IRC provided additional resources for training and administration. The Company facilitated the process by purchasing the camp through tender and additional equipment (including snow machines and ATVs). It also provided hand's-on training in camp management and operation to Inuvialuit residents of Paulatuk. The Company will be reimbursed \$127,448 for the camp purchase, which is the net amount after 113 days of camp rental in 2010 and a 90-day commitment in 2011.
- Diadem Resources Ltd. reported analysis of kimberlite samples from the 2010 drill core obtained from the three newly discovered kimberlite pipes. Reports received from CF Mineral Research Ltd. indicate the presence of a high incidence of kimberlite indicator minerals (chrome diopside, olivine, purple and orange garnets of particular note is the presence of one microdiamond which measured approximately 0.25mm in diameter). Microprobe analyses of kimberlitic indicator mineral grains are considered encouraging, indicating favorable diamond preservation conditions.
- The 2010 work on the 33 Parry Peninsula claims included a land survey on 24 of these claims. Nine of these claims reached their 10-year anniversary and were taken to lease in early 2011. The land surveys are a necessary part of this process. An assessment report was filed for this work, resulting in a refund of \$80,847.52 in extension deposits due from Indian & Northern Affairs Canada to the Company's partnership with Diadem Resources Ltd.

## SELECTED ANNUAL INFORMATION

	2010	2009	2008
Net income (loss) (in thousands)	10	(492)	(632)
Income (loss) per common share	0.00	(0.01)	(0.01)
Total assets (in thousands)	7,873	4,777	638
Shareholders' equity (in thousands)	6,895	2,900	(1,432)

## BALANCE SHEET AND OPERATIONS

At December 31, 2010, assets totaled \$7,873,360 compared to \$4,777,386 at year end December 31, 2009. This amount includes a cumulative mineral property expense at the year end of \$5,709,011 (\$671,340 in 2009) and a total receivable amount of \$594,344 compared to \$131,823 in 2009. The current liability decreased to \$978,198 from \$1,877,231 at the 2009 year-end. The share capital increased to \$25,739,681 from \$23,192,738 in 2009 through the issue of 14,845,931 common shares (39,987,633 in 2009) for \$5,170,327 (\$5,698,626 in 2009) less \$855,599 (\$1,691,100 in 2009) representing the fair value of warrants, \$1,231,200 (\$471,402 in 2009) for the tax effect of flow-through shares and \$658,691 (\$968,182 in 2009) in share issue cost. There were 100,000 shares issued upon the exercise of options for \$10,000, a debt conversion for 3,041,361 shares valued at \$718,466 and the addition of the fair value of options exercised of \$6,070, fair value of warrants exercised of \$20,940 and fair value of compensation options exercised of \$95,096 (\$nil in 2009). The stock options granted and exercised in the current period resulted in stock-based compensation expense of \$540,400 (2009 - \$227,940) and agent's options issued and exercised had a net value of \$164,581 (\$422,000 in 2009). The Company reported a net income at December 31, 2010 of \$9,590 compared to a net loss of \$492,463 in 2009. 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, 2010, the Company had cash resources of \$1,214,083 compared to \$3,965,696 at the 2009 year-end. There were 11,804,570 shares issued for cash totaling \$4,451,861 during the year through brokered private placements, exercise of options, agent's compensation options and warrants (39,987,633 shares issued for \$5,698,626 in 2009). A further 3,041,361 shares were issued through debt conversion for a \$718,466 reduction in payables (\$nil in 2009). The Company has working capital of \$1,186,151 compared to \$2,228,815 at year-end 2009 and an accumulated deficit of \$23,132,085 (\$23,141,675 at the 2009 year-end). The Company is actively working to reduce liabilities through ongoing communication with primary creditors and, if necessary, further debt settlement is planned where allowable.

The Company's current funding objective is to support a metal exploration program and fulfill its obligations to the Inuvialuit Regional Corporation. At the year-end, financial resources were sufficient to allow for an ongoing exploration program including geophysical analysis and drilling. At the same time, the Company is negotiating future

diamond exploration options with Diadem Resources Ltd. The ability to raise the capital resources to undertake these projects is dependent upon the venture capital market and metal prices.

#### SUMMARY OF QUARTERLY RESULTS

<i>for the three month period ended</i>	<i>Dec. 31</i>	<i>Sept. 30</i>	<i>June 30,</i>	<i>Mar. 31</i>
	<i>2010</i>	<i>2010</i>	<i>2010</i>	<i>2010</i>
Net (income) loss (in thousands)	(1,054)	709	209	126
Loss (income) per common share	(0.00)	0.01	0.01	0.01
Total assets (in thousands)	7,873	8,907	4,316	4,371
Shareholders' equity (in thousands)	6,895	7,058	3,388	3,511

  

<i>for the three month period ended</i>	<i>Dec. 31</i>	<i>Sept. 30</i>	<i>June 30</i>	<i>Mar. 31</i>
	<i>2009</i>	<i>2009</i>	<i>2009</i>	<i>2009</i>
Net loss (in thousands)	(36)	147	274	107
Loss per common share	0.01	0.01	0.01	0.01
Total assets (in thousands)	4,777	959	883	592
Shareholders' equity (deficiency) (in thousands)	2,900	(1,364)	(1,447)	(1,539)

#### ANALYSIS OF MINERAL PROPERTY EXPENDITURES

	<i>2010</i>	<i>2009</i>
Project management	91,640	60,620
Project consulting fees	137,943	16,349
Licenses and permits	39,888	64,744
Property access and agreement costs	<u>4,768,200</u>	<u>90,151</u>
	5,037,671	231,864

#### ANALYSIS OF CORPORATE AND GENERAL EXPENSES

	<i>2010</i>	<i>2009</i>
Project evaluation and management services	139,850	113,475
Stock based compensation	540,400	227,940
Administration services	71,193	101,853
Office support services & supplies	107,830	65,255
Accounting services	78,450	45,000
Premises rent	60,196	58,165
Legal fees	41,375	14,202
Audit fees	39,925	25,700
Stock transfer/exchange fees	53,342	39,042
Shareholder communication	73,459	54,549
Interest	19,254	221,899
Miscellaneous	<u>-</u>	<u>250</u>
	1,225,274	967,330

## COMMON SHARES ISSUED

Common shares issued at December 31, 2010 were 103,584,645 and at December 31, 2009 were 88,738,714. During the year, there were 291,667 shares issued through the exercise of \$0.24 warrants and 36,750 through the exercise of \$0.25 warrants, and there were 751,153 shares issued through compensation options exercised at \$0.15. In addition, there were 100,000 shares issued through the exercise of \$0.10 options and 3,041,361 shares issued through debt conversion. On August 25, 2010, there were 10,625,000 share purchase units sold through private placement at \$0.40 per unit. Each unit holder is entitled to one flow share and one half of one share purchase warrant. The 5,312,500 warrants are exercisable for a two year period at \$0.45. The agent received a compensation option to purchase 1,062,500 broker units with the same terms.

On December 31, 2009, there were 33,333,334 shares issued, which included 24,443,368 common shares and 8,889,966 flows-through shares, at \$0.15. Common shares issued had share purchase warrants attached which allowed holder to purchase an additional 12,221,684 shares at \$0.25 for three years. There were 3,333,333 agent's options granted. The option is open for three years and consists of a unit for one common share and one half of one common share purchase warrant for \$0.15. The additional 6,654,299 issued in 2009 include 2,475,000 shares issued at \$0.10, the 791,633 flow-through shares issued at \$0.12 and the 2,720,000 common shares issued at \$0.10 plus 534,000 common shares and 133,666 flow-through shares at \$0.12 and \$0.15 that were subscribed for in December 2008 and issued in January, 2009.

Outstanding share purchase options granted to directors, officers and consultants include 2,600,000 at \$0.10 (expiring on August 5, 2011), 300,000 at \$0.15 (expiring on November 12, 2011) and 300,000 at \$0.32 (expiring on November 27, 2011). There were 300,000, exercisable for \$0.27 for a two year period granted on July 27 and 1,750,000 granted on September 1, 2010 exercisable at \$0.37 for five years. All are in accordance with the Company's Stock Option Plan (see note 6(e) of the audited financial statements). There are 41,866 shares held in escrow.

## 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, Chairman/director) were \$48,000 (\$48,000 in 2009), rent and office services amounts were \$60,196 (\$58,165 in 2009) and \$7,277 (\$9,678 in 2009) respectively. Mr. La Prairie charged \$77,000 for consulting services (2009 - \$57,750) as Chairman. Reimbursable expenses including travel, office and meeting costs for 2010 totalled \$3,078 (\$1,918 in 2009).

In 2010, Stephen Reford, CEO/director charged \$38,850 for professional fees related to executive management (\$31,750 in 2009). Fees relating to deferred project expense of

\$111,390 were charged in 2010 (\$46,684 in 2009). Reimbursable property expenses including travel amounted to \$32,213 compared to \$13,819 in 2009 and corporate administration expenses totaled \$8,774 (\$nil in 2009).

Legal fees were \$42,907 in 2008. Patricia Mannard, Chief Financial Officer provided corporate maintenance and accounting management services in the amount of \$78,450 in 2010 and \$45,000 in 2009. Donald Yamkowy charged the Company \$25,805 (2009 - \$7,735) in project development expenses and \$17,632 (\$8,218 in 2009) in reimbursable expenses. Greg O'Halloran appointed Corporate Secretary of the Company in 2010 charged \$46,154 for consulting services. A legal firm of which director Mark Bennett is a partner provided legal services, related to the issuance of shares, in the amount of \$35,102 (\$nil in 2009).

As at December 31, 2010, accounts payable to the above related parties total \$129,162 (2009 - \$741,856).

At the time of this report, the directors and officers of the Company hold share purchase options. Each of Reford, La Prairie and Mannard have options to purchase 600,000 shares at \$0.10 up to August 5, 2011. An additional 900,000, \$0.10 options are available to three directors with the same terms. There are 300,000 options at \$0.15 expiring on November 12, 2011 and 300,000 at \$0.32 expiring on November 27, 2011 available to the remaining two directors. On July 27, 2010, there were 300,000 two year options granted to the new director Jay Richardson exercisable at \$0.27. On September 1, 2010, Reford and La Prairie were granted an additional 400,000 options exercisable at \$0.37 for five years, Mannard was granted 200,000 and the remaining five directors were granted 100,000 each with the same terms.

#### COMMITMENTS

Notes 4 and 11 of the financial statements for the year ended December 31, 2010 cover the intent of current agreement conditions with the Inuvialuit Land Corporation, the status of the relationship with Diadem Resources Ltd. regarding future exploration of diamonds and other commitments to finders and the Company's agent.

On December 22, 2009, the Company renewed terms with the Inuvialuit Land Corporation for access to the property in the area surrounding Paulatuk, Northwest Territories, for the purpose of base metal exploration.

On July 7, 2010, the Company signed a memorandum of understanding to form a joint venture with Diadem Resources Ltd.; formerly this has been expressed as an agreement held with Carnarvon Capital Corporation, to operate a diamond exploration program. The joint venture will renew a letter agreement with the Inuvialuit Land Corporation allowing access to the property that lies within the Inuvialuit Settlement Region.

## CRITICAL ACCOUNTING ESTIMATES

The preparation of its financial statements requires the Company to use estimates and assumptions that affect the reported amounts of assets and liabilities as well as revenues and expenses.

Our discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with Canadian Generally Accepted Accounting Principles. Our significant accounting policies are contained in Note 2 to the audited financial statements for the year ended December 31, 2010 and changes in those policies. Certain of these policies involve critical accounting estimates because they require us to make particularly subjective or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts could be reported under different conditions or using different assumptions.

The following section discusses the critical accounting estimates and assumptions that management has made and how they affect the amounts reported in the financial statements. We consider these estimates to be an important part of understanding our financial statements.

### *Asset Impairment*

The Company reviews the carrying values of its deferred exploration expenditures whenever events or changes in circumstances indicate that their carrying values may exceed their estimated recoverable amounts determined by reference to estimated undiscounted future cash flows.

The recoverability of amounts shown is dependent upon the discovery of economically recoverable mineral reserves, the ability of the Company to finance the development of the properties, and on the future profitable production or proceeds from the disposition thereof. An impairment loss is recognized when the carrying value of those assets exceeds its estimated net recoverable amount.

### *Stock-based Compensation*

The Company uses the fair value method to account for stock options granted to directors, officers, employees and non-employees. Accordingly, the fair value of the options at the date of grant is either charged to operations or capitalized to exploration of development expenditures, as appropriate, with an offsetting credit to contributed surplus, over the vesting period of the option. If and when the stock options are exercised, the applicable amounts of contributed surplus are transferred to share capital.

### *Warrants*

Warrants issued as part of a private placement unit are valued using the Black-Scholes model. The proceeds from the issue of units are allocated between share capital and

warrants on a pro-rata basis based on the relative fair values. The related charge is allocated to the appropriate expense or asset category when issued for services or to equity when issued for cash.

#### *Asset Retirement Obligations*

Asset retirement obligations are recognized in the period in which they are incurred if a reasonable estimate of fair value can be determined. An asset retirement obligation is an existing legal obligation associated with the permanent removal from service of a long-lived asset, which results from the acquisition, construction, development or normal operation of the asset. The obligation is measured at fair value and is adjusted in subsequent periods through accretion expense.

The associated asset retirement costs are capitalized as part of the carrying amount of the related asset. Estimating the costs of asset retirement obligations requires extensive judgment about the nature and timing of work to be carried out in view of present environmental laws and regulations, and these estimates are subject to considerable uncertainty. Changes in these estimates could have a material impact on our results of operation and financial position.

#### ENVIRONMENTAL RISKS AND HAZARDS

All phases of the Company's mineral exploration operations are subject to environmental regulations pertaining to the Northwest Territories and Canada. Environmental legislation is evolving in a manner which will require stricter standards and enforcement, increased fines and penalties for non-compliance, more stringent environmental assessments of proposed projects and a heightened degree of responsibility for companies and their officers, directors and employees. There is no assurance that future changes in environmental regulation, if any, will not adversely affect the Company's operations. Environmental hazards may exist on the properties on which the Company holds interests which are unknown to the Company at present and which have been caused by previous or existing owners or operators of the properties. The Company may become liable for such environmental hazards caused by previous owners and operators of the properties even where it has attempted to contractually limit its liability.

Government approvals and permits are currently, and may in the future be, required in connection with the Company's operations. To the extent such approvals are required and not obtained; the Company may be curtailed or prohibited from proceeding with planned exploration or development of mineral properties. Failure to comply with applicable laws, regulations and permitting requirements may result in enforcement actions there under, including orders issued by regulatory or judicial authorities causing operations to cease or be curtailed, and may include corrective measures requiring capital expenditures, installation of additional equipment, or remedial actions. Parties engaged in mining operations may be required to compensate those suffering loss or damage by reason of the mining activities and may have civil or criminal fines or penalties imposed for violations of applicable laws or regulations.

The future costs of retiring mining assets include dismantling, remediation, ongoing treatment and monitoring of the site. These are reconciled and recorded as a liability at fair value. The liability is accreted, over time, through periodic charges to earnings. In addition, asset retirement costs are capitalized as part of the asset's carrying value and amortized over the asset's useful life. As the Company has not yet begun mining or milling operations, the Company currently has no identifiable obligations relation to the retirement of its assets.

Amendments to current laws, regulations and permits governing operations and activities of mining companies, or more stringent implementation thereof, could have a material adverse impact on the Company and cause increases in exploration expenses, capital expenditures or production costs or reduction in levels of production at producing properties or require abandonment or delays in development of new mining properties. Production of mineral properties may involve the use of dangerous and hazardous substances. While all steps will be taken to prevent discharges of pollutants into the ground water and the environment, the Company may become subject to liability for hazards that cannot be insured against. The Company is subject to all environmental acts and regulations at the federal and provincial levels.

#### MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

In connection with Exemption Orders issued in November 2007 by each of the securities commissions across Canada, the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") of the Company will file a Venture Issuer Basic Certificate with respect to the financial information contained in the unaudited interim financial statements and the audited annual financial statements and respective accompanying Management's Discussion and Analysis.

In contrast to the certificate under Multilateral Instrument ("MI") 52-109 (Certification of Disclosure in Issuer's Annual and Interim Filings), the Venture Issuer Basic Certification includes a 'Note to Reader' stating that the CEO and CFO do not make any representations relating to the establishment and maintenance of disclosure controls and procedures and internal control over financial reporting, as defined in MI 52-109.

#### STATUS OF TRANSITION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

On February 13, 2009, the CICA Accounting Standards Board (AcSB) confirmed that the changeover to IFRS from Canadian GAAP will be required for publicly accountable enterprises for interim and annual financial statements effective for fiscal quarters beginning on or after January 1, 2011, including comparatives for 2010. The objective is to improve financial reporting by having one single set of accounting standards that are comparable with other entities on an international basis.

The Company commenced its IFRS conversion project during 2009 and established a project governance structure, to monitor the progress and critical decisions in the transition to IFRS. The external auditors have also been consulted throughout the process.

The Company's conversion project has been structured in four phases: preliminary study, evaluation, development, and implementation. To date, the project is progressing according to plan. During 2009 the Company completed the preliminary study phase of the project which involved a high level review of the major differences between current Canadian GAAP and IFRS as related to the Company's accounting policies. During 2009 the Company completed a preliminary in-depth review of its accounting policies and the impact from adopting IFRS, as well as the associated impact of the IFRS transition on business activities.

As of December 31, 2010, the Company had substantially completed the evaluation and development phases of its IFRS conversion project. The following areas have been identified where the accounting differences, including presentation and disclosures, between Canadian GAAP and existing IFRS may have an impact on the Company's financial statements. The accounting differences described below should not be regarded as a complete list of areas that may be impacted by the transition to IFRS. Analysis of accounting policies has substantially been completed, but may be subject to changes as the Company completes the implementation phase of the project, and where IFRS standards are likely to change.

The Company is currently working through the implementation phase. Draft IFRS financial statements are being developed and are about to undergo a thorough review process with the involvement of the Company's auditors and outside consultants. Significant differences between Canadian GAAP and IFRS impacting the Company's opening balance sheet for January 1, 2010 are in the process of being finalized. The Company will prepare IFRS financial statements for its first quarter of fiscal 2011.

The audit committee of the Company is kept informed of management's decision on accounting policy choices under IFRS.

The International Accounting Standards Board has a number of ongoing projects, the outcome of which may have an effect on the changes required to the Company's accounting policies on adoption of IFRS. At the present time however, the Company is not aware of any significant expected changes that would affect the summary provided below. As an update to our previously filed annual and quarterly MD&As, the following provides a summary of the Company's evaluation of potential changes to accounting policies in key areas based on the current standards and guidance within IFRS.

### **Mineral properties**

- Upon transition to IFRS, the Company intends on retaining its accounting policies and practices (as an allowable option) it has applied previously under Canadian GAAP, relating to the recognition of mineral properties, in which case it would continue to capitalize exploration and evaluation ("E&E") expenditures under IFRS, and classify them as either tangible or intangible assets, according to their nature, as required by IFRS. The Company is currently evaluating whether there may be any general expenses that are not directly attributable to any specific

mineral property, and determine their appropriate accounting treatment under IFRS.

- IFRS 6, *Exploration for and Evaluation of Mineral Resources* applies only to the exploration and evaluation (“E&E”) stage, and does not apply to the development and production stages of the mineral reserves development process. Additionally when the technical feasibility and commercial viability of extracting mineral resources is demonstrable, IFRS 6 requires exploration and evaluation assets to cease being classified as such. However as this would be outside the scope, IFRS 6 does not specify where they can be reclassified. It is an accounting policy choice that is available to the Company, which needs to be clearly stated and applied consistently. The choice is again between capitalizing the assets as either tangible or intangible assets. The Company’s project is in exploration and evaluation stage, thus IFRS 6 will apply, and the Company’s mineral property costs will be classified as intangibles.
- The Company currently intends on continuing to use the cost model for its mineral properties, and not apply the revaluation model available under IFRS.

### **Impairment of Assets**

- The Company is currently in the process of evaluating whether there would be any asset impairment at the transition date under IFRS. In assessing whether there is any indication that an asset may be impaired, an impairment test should be performed; consideration would be given to the external and internal sources of information, as prescribed by IAS 36, *Impairment of Assets*. Impairment under IFRS is recognized if the carrying amount exceeds the higher of fair value less cost to sell, or value in use.

### **Share Based Payments**

- Under IFRS, each vesting group of stock options is treated as a distinct award / tranche and the value would be measured and recorded over the respective vesting period. Additionally, an estimate of expected forfeitures would be required when determining the amount of expense to be recorded for the unvested portion as at transition date, as well as going forward.
- The Company is currently in the process of reviewing any stock options that remain unvested at January 1, 2010, and adjust the recording of the expense based on the IFRS requirement.

### **Income taxes**

- Currently, the Company is following guidance under EIC 146, *Flow-Through Share*, which indicates that on the date of share issuance, the future income tax liability should be recognized and the shareholders’ equity should be reduced.

- Under IFRS, there is no specific guidance to this regard, and the Company would have one of the following options discussed below. Upon issuance of flow-through shares, due to the fact that investor received both equity interest and a right to a stream of tax deductions, it would have to be assessed whether transaction should be treated as a compound financial instrument or a multiple element arrangement under IAS 32, *Financial Instruments: Presentation*, IAS 39, *Financial Instruments: Recognition and Measurement*, and IAS 18, *Revenue*. Once liability portion has been separately recognized upon initial issuance of flow-through shares, the Company has one of two choice:
  1. Reverse the liability to profit or loss, since IAS 12, *Income Taxes*, requires that a deferred tax liability be recognized for all temporary differences except to the extent that the deferred tax liability arises from the initial recognition of an asset or liability in a transaction which is not a business combination and at the time of the transaction, affects neither accounting profit not taxable profit (loss). As such, there will be no deferred taxes relating to the liability portion of the flow-through shares, and entire liability is reversed to profit or loss.
  2. Reverse liability, and recognized deferred tax liability for the entire taxable portion of the flow-through shares. The amount by which deferred tax liability exceeds the flow-through liability would be recorded as a tax expenses in profit or loss.
- The Company does not expect any substantial impact relating to the adoption of the IFRS standard on income taxes.

### **Presentation of Financial Statements**

- The conversion to IFRS will impact the way the Company presents its financial results. The first financial statements prepared using IFRS (i.e. interim financial statements for the three months ended March 31, 2011) will include numerous notes disclosing extensive transitional information with continuity reconciliations and full disclosure of all new IFRS accounting policies.
- The Company does not expect substantial changes on the presentation of expenses whether by nature or by function on the face of the statement of loss.

### **IFRS 1, First Time Adoption of IFRS**

#### Deemed cost

Upon transition, the Company intends on measuring mineral properties at their deemed cost equivalent to fair value as at January 1, 2010 or revalue amounts previously determined under Canadian GAAP. Accordingly, it would use the carrying values as the IFRS balances as at January 1, 2010.

## Share-based payments

IFRS 1 provides an exemption that allows entities not to apply IFRS 2, *Share-based Payment* to options granted before November 2002, as well as to options granted after November 2002, but vested prior to transition. The Company intends on taking this exemption

## RISKS AND UNCERTAINTIES

The business of the Company involves many risks and uncertainties. Metal exploration involves a high level of risk. Some of the risks include the lack of revenues as the Company is a development stage enterprise. Other risks include the difficulty of finding, assessing and developing an economically viable ore deposit, intense competition in the sector from both large and small competitors, fluctuations in metal prices and currency exchanges, risks associated with renunciation and expenditure of costs relating to flow-through shares and the possibility of legal challenges from environmental and aboriginal groups. These are not an exhaustive list of the risks associated with the business.

## CORPORATE GOVERNANCE

The Company's Corporate Governance Policy can be viewed on [www.sedar.com](http://www.sedar.com). The policy is amended annually and appears as an appendix to the Company's Management Information Circular. The Company maintains its commitment to achieve full compliance with the policy.

## OUTLOOK

The Company has focused its marketing and financing initiatives on Canada, China and Russia to seek new sources of financing and potential joint venture partners. The ongoing support from the Inuvialuit Regional Corporation (IRC), the community of Paulatuk and other local participants is encouraging. The purpose of the exploration and drilling is to locate metal and diamond deposits for eventual development.

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 YEAR ENDED DECEMBER 31, 2010, WHICH ACCOMPANY THIS ANALYSIS AND, ALTERNATELY, ARE AVAILABLE ALONG WITH ALL THE COMPANY'S PUBLIC DOCUMENTS ON [WWW.SEDAR.COM](http://WWW.SEDAR.COM)

[www.darnleybay.com](http://www.darnleybay.com) TSX Venture Exchange Symbol DBL

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

FINANCIAL STATEMENTS

DECEMBER 31, 2010 and 2009

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

FINANCIAL STATEMENTS

DECEMBER 31, 2010 and 2009

I N D E X

INDEPENDENT AUDITORS' REPORT	1
BALANCE SHEETS	2
STATEMENTS OF INCOME (LOSS), COMPREHENSIVE INCOME (LOSS) AND DEFICIT	3
STATEMENTS OF CASH FLOWS	4
NOTES TO FINANCIAL STATEMENTS	5 - 24



## INDEPENDENT AUDITORS' REPORT

To the Shareholders of  
Darnley Bay Resources Limited:

We have audited the accompanying financial statements of Darnley Bay Resources Limited (the "Company"), which comprise the balance sheets as at December 31, 2010 and 2009, and the statements of income (loss), comprehensive income (loss) and deficit, and cash flows for each of the years then ended, and summary of significant accounting policies and other explanatory information.

### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

### Auditors' Responsibility

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 comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

### Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Darnley Bay Resources Limited as at December 31, 2010 and December 31, 2009 and the results of its operations and its cash flows for each of the years then ended in accordance with Canadian generally accepted accounting principles.

*(Signed) "Edmund Cachia & Co.LLP"*

Toronto, Ontario, April 29, 2011

CHARTERED ACCOUNTANTS  
Licensed Public Accountants

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

BALANCE SHEETS

DECEMBER 31

	2010	2009
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash	\$ 1,214,083	\$ 3,965,696
Accounts receivable	594,344	131,823
Advances (note 12)	221,949	-
Prepaid expenses and deposits	<u>133,973</u>	<u>8,527</u>
	2,164,349	4,106,046
 MINERAL PROPERTY (note 3)	 <u>5,709,011</u>	 <u>671,340</u>
	<u>\$ 7,873,360</u>	<u>\$ 4,777,386</u>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Accounts payable and accrued liabilities (note 5)	\$ 978,198	\$ 1,877,231
<b>SHAREHOLDERS' EQUITY</b>		
CAPITAL STOCK (note 6(b))	25,739,681	23,192,738
SHARE PURCHASE WARRANTS (note 6(c))	2,525,759	1,691,100
CONTRIBUTED SURPLUS (note 8)	1,761,807	1,157,992
DEFICIT	<u>( 23,132,085)</u>	<u>( 23,141,675)</u>
	<u>6,895,162</u>	<u>2,900,155</u>
	<u>\$ 7,873,360</u>	<u>\$ 4,777,386</u>

Commitments (note 11)  
Going concern basis (note 1)

Approved by the Board:

(Signed) "Stephen Reford" \_\_\_\_\_, 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 INCOME (LOSS), COMPREHENSIVE INCOME (LOSS) AND DEFICIT  
FOR THE YEARS ENDED DECEMBER 31

	2010	2009
<b>EXPENSES</b>		
Office administration services	\$ 257,472	\$ 212,359
Project evaluation costs	139,850	113,475
Professional fees	88,886	71,159
Premises rent	60,196	58,165
Shareholder communication	119,216	62,333
Stock option compensation cost (note 6(e))	540,400	227,940
Interest expense	<u>19,254</u>	<u>221,899</u>
Income (loss) before the under noted	( 1,225,274)	( 967,330)
Interest income	<u>3,664</u>	<u>3,465</u>
Income (loss) before income taxes	( 1,221,610)	( 963,865)
Future income tax recovery (note 7(b))	<u>1,231,200</u>	<u>471,402</u>
<b>NET INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS) FOR THE YEAR</b>	9,590	( 492,463)
<b>DEFICIT AT BEGINNING OF THE YEAR</b>	( 23,141,675)	( 22,649,212)
<b>DEFICIT AT END OF THE YEAR</b>	<u>(\$ 23,132,085)</u>	<u>(\$ 23,141,675)</u>
Basic and diluted income (loss) per share (note 2)	<u>\$ 0.00</u>	<u>(\$ 0.01)</u>
Weighted average number of common shares outstanding	<u>95,384,391</u>	<u>52,987,500</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 YEARS ENDED DECEMBER 31

	2010	2009
<b>CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES:</b>		
Net income (loss) for the year	\$ 9,590	(\$ 492,463)
Non-cash items:		
Stock option compensation cost	540,400	227,940
Future income tax recovery	( 1,231,200)	( 471,402)
Net changes in working capital balances:		
Decrease (increase) in accounts receivable	( 462,521)	1,625
Increase in advances	( 221,949)	-
Increase in prepaid expenses	( 125,446)	( 8,527)
Decrease in accounts payable and accrued liabilities	<u>( 180,567)</u>	<u>( 192,514)</u>
Cash (used in) operations	<u>( 1,671,693)</u>	<u>( 935,341)</u>
<b>CASH (USED IN) INVESTING ACTIVITIES:</b>		
Increase in mineral property	<u>( 5,037,671)</u>	<u>( 231,865)</u>
Cash (used) in investments	<u>( 5,037,671)</u>	<u>( 231,865)</u>
<b>CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES:</b>		
Issue of common shares	4,451,861	5,614,496
Share issue costs	<u>( 494,110)</u>	<u>( 546,182)</u>
Cash provided by financing	<u>3,957,751</u>	<u>5,068,314</u>
<b>INCREASE (DECREASE) IN CASH POSITION</b>	<b>( 2,751,613)</b>	<b>3,901,108</b>
<b>CASH POSITION AT BEGINNING OF THE YEAR</b>	<b><u>3,965,696</u></b>	<b><u>64,588</u></b>
<b>CASH POSITION AT END OF THE YEAR</b>	<b><u>\$ 1,214,083</u></b>	<b><u>\$ 3,965,696</u></b>
<b>Supplementary disclosure of non-cash items:</b>		
Shares issued for non-cash consideration:		
Issuance of common shares for debt	\$ 718,466	\$ -
Fair value of agent's options (note 6(d))	\$ 164,581	\$ 422,000
Shares issuable at December 31, 2008, issued in 2009	\$ -	\$ 84,130
Tax effect of flow-through shares	\$ 1,231,200	\$ 471,402

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, 2010 AND 2009

1. NATURE OF OPERATIONS AND GOING CONCERN CONSIDERATIONS:

The Company is in the business of exploring for 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.

For the year ended December 31, 2010, the Company had income of \$9,590 (2009 – loss of \$492,463) and had an accumulated deficit of \$23,132,085 (2009 - \$23,141,675). As at December 31, 2010, the Company had working capital of \$1,186,151 compared to \$2,228,815 in 2009. These circumstances may cast significant doubt as to the Company's ability to continue as a going concern and the appropriateness of the use of accounting principles applicable to a going concern.

These financial statements have been prepared on the basis of accounting principles applicable to a “going concern”, which assume that the Company will continue in operation for the foreseeable future and will be able to realize its assets and discharge its liabilities in the normal course of operations. The business of mining and exploring for minerals involves a high degree of risk and there is no guarantee that the Company's exploration programs will yield positive results or that the Company will be able to obtain the necessary financing to carry out the exploration and development of its mineral property interests.

These financial statements do not reflect the adjustments to the carrying values of assets and liabilities, or the reported expenses and balance sheet classifications that would be necessary should the going concern assumption be inappropriate. These adjustments could be material.

The recoverability of the carrying value of exploration properties and the Company's continued existence is dependent upon the preservation of its interests in the underlying properties, the development of economically recoverable reserves, the achievement of profitable operations, or the ability of the Company to raise additional financing, if necessary, or alternatively upon the Company's ability to dispose of its mineral property interests on an advantageous basis. Changes in future conditions could require material write-downs of the carrying values.

Although the Company has taken steps to verify title to the properties in which it has an interest, in accordance with industry standards for the current stage of exploration of such properties, these procedures do not guarantee the Company's title. Property title may be subject to government licensing requirements or regulations, unregistered prior agreements, undetected defects, unregistered claims, native land claims, and non-compliance with regulatory and environmental requirements.

2. SIGNIFICANT ACCOUNTING POLICIES:

USE OF ESTIMATES

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

2. SIGNIFICANT ACCOUNTING POLICIES (continued):

USE OF ESTIMATES (continued)

Significant areas requiring the use of management estimates include the continuing viability of mineral property interests, the determination of reclamation obligations, the recoverability of accounts receivable, the fair value of financial assets and liabilities, valuation allowance recognized for future income taxes, and assumptions used in the determination of the fair value of options and warrants. Actual results could differ from these estimates. Management believes that the estimates are reasonable.

MINERAL PROPERTY AND RELATED EXPENDITURES

Property acquisition costs and related direct exploration costs are deferred until the properties are placed into mineral production, sold or abandoned. These costs will be amortized on the units-of-production basis over the estimated useful life of the properties following the commencement of production or written-off if the properties are sold, allowed to lapse, or abandoned.

Cost includes the cash and other consideration paid, and the fair market value of any common shares issued on the acquisition of mineral properties. Properties acquired under option agreements, whereby payments are made at the sole discretion of the Company, are recorded in the accounts at such time as the payments are made. The recorded cost of mineral claims and deferred exploration and development costs represent costs incurred and are not intended to reflect present or future values.

The recoverability of costs incurred on the exploration properties is dependent upon numerous factors including exploration results, environmental risks, commodity risks, political risks, and the Company's ability to attain profitable production. It is reasonably 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.

The Company reviews capitalized costs on its property interests on a periodic, or annual, basis and will recognize impairment in value based upon current exploration results and upon management's assessment of the future probability of profitable revenues from the property or from the sale of the property. Management's assessment of the property's estimated current fair market value may also be based upon a review of other property transactions that have occurred in the same geographic area as that of the property under review and the assessment of the ability to recover capitalized costs based on technical, social and environmental issues. Administrative costs, other than for those that are charged to mineral property costs, are expensed as incurred. The proceeds of options granted on a mineral property are recorded as a reduction of the amounts recorded for mineral property costs and any excess is recorded in the statement of income (loss), comprehensive income (loss) and deficit.

SHARE CAPITAL

Common shares issued for non-monetary consideration are recorded at their fair market value based upon quoted market prices based on the Company's average share price before and after the transaction. Costs incurred to issue common shares are deducted from share capital.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

2. SIGNIFICANT ACCOUNTING POLICIES (continued):

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, 2010, 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.

STOCK-BASED COMPENSATION

The Company has a stock option plan, which is described in note 6(e). The Company uses the Black-Scholes option pricing model to estimate the fair value of each stock-option at the date of grant. Stock options that vest immediately are recorded at the date of grant. Stock options that vest over time are recorded over their vesting period. Stock option compensation is recognized as an expense with a corresponding increase in contributed surplus. On exercise of the stock option, consideration received and the estimated fair value previously recorded in contributed surplus is recorded as capital stock.

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. For the periods presented, diluted loss per share is not presented, as the effect of outstanding options and warrants is anti-dilutive.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

2. SIGNIFICANT ACCOUNTING POLICIES (continued):

INCOME TAXES

The Company accounts for and measures future tax assets and liabilities in accordance with the asset and liability method. Under this method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amount of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using the enacted or substantially-enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be reversed or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment of the change. When the future realization of income tax assets does not meet the test of being more likely than not to occur, a valuation allowance in the amount of the potential future benefit is taken and no net asset is recognized. Assuming the Company's operations remain at the exploration stage, such an allowance will continue to apply fully for the foreseeable future to all potential income tax assets. Accordingly, the Company's accounting policy for the future income taxes currently has no effect on the financial statements of the fiscal periods presented.

FINANCIAL ASSETS AND LIABILITIES

Assets or liabilities held-for-trading -

Financial instruments classified as assets or liabilities held for trading are reported at fair value at each balance sheet date, and any change in fair value is recognized in net income (loss) in the period which the change occurs.

Held-to-maturity investments, loans and receivables and other financial liabilities -

Financial instruments classified as loans and receivables, held-to-maturity investments and other financial liabilities are carried at amortized costs using the effective interest method. Interest income or expenses is included in net income (loss) over the expected life of the instrument.

Available-for-sale -

Financial instruments classified as available for sale are recorded at fair value at each balance sheet date and any change in fair value is recognized in other comprehensive income in the period in which these changes occur. Securities classified as available for sale and with no quoted market price in an active market are carried at cost. Available-for-sale securities are written down to fair value (impairment recognized in income) when it is necessary to reflect an other-than-temporary impairment. Upon derecognition, any accrued gains or losses in accumulated other comprehensive income are then recognized in net income (loss).

REVENUE RECOGNITION

Interest income is recognized on an accrual basis as it is earned.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

2. SIGNIFICANT ACCOUNTING POLICIES (continued):

CLASSIFICATION OF FINANCIAL INSTRUMENTS

The Company designates its cash as held-for-trading, which is measured at fair value. Accounts receivable and advances are classified as loans and receivables, which are measured at amortized cost. Accounts payable and accrued liabilities are classified as other financial liabilities which are measured at amortized cost. Due to the short-term nature of these instruments, their carrying value approximates their fair value.

COMPREHENSIVE INCOME

Comprehensive income represents a change in shareholders' equity (net assets) of an enterprise during a reporting period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. These items include holding gains and losses on certain investments, gains and losses on certain derivative instruments, and foreign currency gains and losses related to self-sustaining foreign operations.

CAPITAL DISCLOSURES

Section 1535 specifies the disclosure of (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and (iv) if it has not complied, the consequences of such noncompliance. The Company has included disclosures recommended by the Handbook section in note 10 to these financial statements.

FLOW-THROUGH SHARES

The Company may finance a portion of its exploration and development activities through the issue of flow-through shares. Under the terms of these share issues, the tax attributes of the related expenditures are renounced to subscribers. Share capital is reduced and future income tax liabilities are increased by the estimated income tax benefits renounced by the Company to the subscribers, except to the extent that the Company has unrecorded loss carry forwards and tax pools in excess of book value available for deduction, then share capital is reduced and a future income tax recovery is recorded.

FINANCIAL INSTRUMENTS – DISCLOSURE AND PRESENTATION

Sections 3862 and 3863 of the CICA handbook place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. The required disclosures are referred to in Note 9 to these financial statements.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

2. SIGNIFICANT ACCOUNTING POLICIES (continued):

SHARE PURCHASE WARRANTS AND AGENT'S OPTIONS

Options and warrants issued to agents in connection with a financing are recorded at fair value using the Black-Scholes option pricing model and charged to share issue costs associated with the offering with the offsetting credit respectively to contributed surplus or warrants in shareholders' equity.

Warrants issued as part of a private placement unit are valued using the Black-Scholes model. The proceeds from the issue of units is allocated between share capital and warrants on a pro-rata basis based on the relative fair values. The related charge is allocated to the appropriate expense or asset category when issued for services or to equity when issued for cash.

Upon the exercise of warrants or agent's options, the amount relating to the award is transferred from warrants or contributed surplus respectively to share capital and the proceeds received are credited to share capital. When warrants expire, fair value allocated to them is transferred from warrants to contributed surplus.

FAIR VALUE HIERARCHY AND LIQUIDITY RISK DISCLOSURE

The following summarizes the methods and assumptions used in estimating the fair value of the Company's financial instruments where measurement is required. The fair value of short-term financial instruments approximates their carrying amounts due to the relatively short period to maturity. These include cash, receivables and accounts payable and accrued liabilities. Equity investments classified as available for sale that do not have an active trading market are recorded at cost. Fair value amounts represent point-in-time estimates and may not reflect fair value in the future. The measurements are subjective in nature, involve uncertainties and are a matter of significant judgment. The methods and assumptions used to develop fair value measurements, for those financial instruments where fair value is recognized in the balance sheet, have been prioritized into three levels as per the fair value hierarchy included in GAAP. Level one includes quoted prices (unadjusted) in active markets for identical assets or liabilities. Level two includes inputs that are observable other than quoted prices included in level one. Level three includes inputs that are not based on observable market data.

	Level One	Level Two	Level Three
Cash	\$ 1,214,083	\$ -	\$ -

FUTURE ACCOUNTING CHANGES

INTERNATIONAL FINANCIAL REPORTING STANDARDS ("IFRS")

In February 2008, the AcSB announced that 2011 is the changeover date for publicly accountable companies to use IFRS, replacing Canadian GAAP. This date is for interim and annual financial statements relating to fiscal year beginning on or after January 1, 2011. Commencing with the interim period March 31, 2011 the Company will present restated comparative fiscal 2010 financial statements for annual and interim periods to be prepared in accordance with IFRS including the restatement of the opening balance sheet as at January 1, 2010.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

2. SIGNIFICANT ACCOUNTING POLICIES (continued):

FUTURE ACCOUNTING CHANGES (continued)

INTERNATIONAL FINANCIAL REPORTING STANDARDS ("IFRS") (continued)

A changeover plan has been established to convert to the new standards within the allotted timeline. The Company continues to evaluate the impact this will have on the Company's financial statements.

3. MINERAL PROPERTY:

	Cumulative to December 31, 2008	2009 Additions	Cumulative to December 31, 2009	2010 Additions	Cumulative to December 31, 2010
Project management	\$ 60,885	\$ 60,620	\$ 121,505	\$ 91,640	\$ 213,145
Consultants	22,191	16,349	38,540	137,943	176,483
Licenses and permits	163,898	64,745	228,643	39,888	268,531
Property access and exploration costs	192,501	90,151	282,652	4,768,200	5,050,852
	<u>\$ 439,475</u>	<u>\$ 231,865</u>	<u>\$ 671,340</u>	<u>\$ 5,037,671</u>	<u>\$ 5,709,011</u>

See notes 1 and 4 for additional information on mineral properties.

4. AGREEMENTS:

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

Under an agreement (originally dated June 24, 2003) with Carnarvon Capital Corporation ("Carnarvon") and Diadem Resources Ltd. ("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 agreement encompassed mining claims held both in the names of either Darnley Bay Resources Limited or Diadem. The principal terms, as amended from time to time, were 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. By terms of this supplementary agreement, the earn-in amount reflected an additional \$1,000,000 of expenditures to be incurred during the extended period from September 1, 2007 through June 30, 2008 (previously December 31, 2007) and in addition to the approximately \$3.2 million that has been reported as expended by Diadem commencing with the 2005 calendar year. If the funds were spent, Diadem would have earned a 50% participating interest in the selected lands, with the Company holding the other 50%.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

4. AGREEMENTS (continued):

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

Under the November 29, 2007 agreement, once Diadem had earned its interest, it would 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 would 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 was a decision to carry out a feasibility study on the lands selected by Diadem, it would have the right to fund the feasibility study, and if the property is placed into commercial production Diadem's interest would increase to 75% and the Company's interest would decrease to 25%.

At June 30, 2008, Diadem had not met all the requirements of the November 29, 2007 agreement.

On July 7, 2010, the Company and Diadem signed a memorandum of understanding regarding their future cooperation. Under this memorandum the following issues related to the cooperation of two companies have been resolved:

- Debt owing to the Company by Diadem has been capped at \$115,000 (received) and was payable in full on signing.
- The Company and Diadem shall further cooperate on creating a joint venture to perform exploration on Parry Peninsula, Northwest Territories
- Diadem has to spend \$2 million in exploration expenditures by June 30, 2011 on properties to be jointly explored in order to earn a 50%/50% interest in a future joint venture with the Company. In case Diadem fails to incur required expenditures, its interest in the joint venture would be reduced to 25%. However, if Diadem will remedy the situation by December 31, 2011, 50% interest would be reinstated.
- Once joint venture is formed, a cooperation agreement would be signed with the Inuvialuit Regional Corporation to set out terms of the exploration work to be performed by joint venture.
- All claims in the Parry Peninsula held by either of the two parties would be transferred to a joint venture.
- The joint venture shall reimburse the Company for all the costs it has incurred on Parry Peninsula Land during 2010, which is estimated to be \$328,000.

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 would enter into a Cooperation and Benefits Agreement with the Inuvialuit. The principal terms are as follows:

The agreement would cover 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).

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

4. AGREEMENTS (continued):

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

The agreement was 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 would be granted access to the Inuvialuit lands to conduct exploration, development and extraction operations for rough diamonds. The joint venture would be required to obtain all necessary permits and approvals, and would pay the fees and charges under the Inuvialuit Rules with a minimum amount payable each year of \$50,000.

The joint venture was to incur at least \$2 million of work by September 30, 2005. All costs to be expended under the terms of the agreement were 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 were 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 was to receive a 2% diamond royalty on mining rights exploited by the joint venture. (The Inuvialuit could hold certain claims in the area and obtain a 15 year deferral of Crown royalties. If the Inuvialuit did so, in such cases the Inuvialuit would 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 preparing the feasibility study.

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 combined metals and diamonds concession agreement (the "Concession") was signed on December 22, 2009 for the 7(1)(a) lands to clarify the formal commitment. Prior to signing of the agreement, as a pre-condition, on December 29, 2009 the Company paid 50% (\$626,268) of its outstanding debt to the Inuvialuit Regional Corporation. According to the agreement, all activities and consequently all payments and required work commitments are divided into three stages:

1. Exploration stage - valid for a 10 year period, and can be renewed for two more three year periods for \$150,000 for each renewal (adjusted for inflation). A contiguous 50% of the remaining land area of the Concession shall be dropped upon each extension, subject to any areas designated being excluded from the total land area from which 50% must be dropped. The start of the exploration stage is deemed to be the date of the signing of the agreement. Cash payments and work commitments in this stage are as follows:

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

4. AGREEMENTS (continued):

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

	Cash payments	Work commitment	Work commitments met at December 31, 2010
2010	\$ 50,000 (fulfilled)	\$ 2,000,000	\$ 2,000,000
2011	50,000	2,000,000	2,000,000
2012	50,000	2,000,000	1,045,637
2013	50,000	1,000,000	-
2014	50,000	1,000,000	-
2015	*125,000	1,000,000	-
2016	*125,000	1,000,000	-
2017	*125,000	1,000,000	-
2018	*125,000	1,000,000	-
2019	*125,000	1,000,000	-
	<u>\$ 875,000</u>	<u>\$ 13,000,000</u>	<u>\$ 5,045,637</u>

\* plus applicable access fees.

In any year, the work commitment is reduced by the percentage of lands that have been designated as project areas and preceded to the second stage of activities. For each renewal period the Company has to incur \$1,000,000 in work commitments per year to maintain its concession rights. Any underperformed amount of work commitment in any year can be paid in cash.

- Project definition stage – the Company defines project areas within the concession on which it will be conducting continuous exploration activities. The term is for 10 years with respect to metals from the time of designation and 6 years with respect to diamonds. The Company has an option to extend this stage for an additional 5 years for metals and 2 years for diamonds for \$150,000 for each extension. During the project definition stage, the annual fee is \$100,000 per year plus \$48.00 per square kilometer, adjusted for inflation, and the same fees as in Exploration stage apply to any lands that are not designated.

At this stage, the Company has to incur \$10 per acre in the first five years and \$20 per acre in subsequent years for minimum cumulative work of \$500,000 on each project.

- Production stage – the Company is entitled to the issuance of the mining lease, if it will be able to start production within 36 months of the issuance of the lease. The mining lease is valid for 15 years with respect to metals and 10 years with respect to diamonds. The amount of annual fees to be paid will be determined at the time of issuance of the mining lease.

The Agreement is subject to a 6% NSR for both diamonds and metals. During each year of the mining lease, the minimum amount of the royalty should be \$800,000.

The Inuvialuit Mining Corporation has an option to a 10% participating interest in any mining lease by reimbursing the Company the proportionate amount of costs that have been incurred during the project definition stage.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

5. RELATED PARTY TRANSACTIONS:

During the year, a company controlled by the Chairman and director of the Company, charged \$48,000 (\$48,000 in 2009) for management fees, \$60,196 for rent (\$58,165 in 2009) and \$7,277 for offices services (\$9,678 in 2009). Management fees in the amount of \$77,000 (2009 - \$57,750) were charged by the Chairman and director directly plus reimbursable office and meeting expenses of \$3,078 (\$1,918 in 2009).

Professional fees amounting to \$38,850 were charged by the Chief Executive Officer in 2010 and \$31,750 in 2009. Fees associated with deferred mineral property expense of \$111,390 were charged in 2010 (\$46,684 in 2009). There were reimbursable property expenses including travel charged by the individual in the amount of \$32,213 compared to \$13,819 in 2009 and corporate administration expenses totalling \$8,774 (\$nil in 2009).

Consulting fees amounting to \$46,154 (2009 - \$nil) were charged by directors of the Company.

Legal fees related to the issuance of shares during the year amounting to \$35,102 (2009 - \$nil) were charged by a law firm of which a director of the Company is a partner.

Corporate maintenance and accounting management fees amounting to \$78,450 (2009 - \$45,000) were charged by a director and officer of the Company.

During the year, a Director of the Company charged consulting fees in the amount of \$25,805 (2009 - \$7,735) and reimbursable expenses in amount of \$17,632 (2009 - \$8,218) for services provided with regards to exploration activities of the Company.

As at December 31, 2010, accounts payable include \$129,162 (2009 - \$741,856) 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 management believes approximates fair value), which is the amount of consideration established and agreed to by the parties.

See note 6 (b) for additional related party information regarding debt conversion.

6. CAPITAL STOCK:

a) Authorized:

An unlimited number of common shares

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

6. CAPITAL STOCK (continued):

b) Common shares issued:

	2010		2009	
	Shares	Amount	Shares	Amount
Balance, beginning of the year	88,738,714	\$ 23,192,738	48,751,081	\$ 20,624,796
Issued for cash under private placements	10,625,000	4,250,000	39,987,633	5,698,626
Issued upon exercise of options for cash (see below)	100,000	10,000	-	-
Fair value of options exercised (note 8)	-	6,070	-	-
Issued upon exercise of warrants for cash	328,417	79,188	-	-
Fair value of warrants exercised (note 6(c))	-	20,940	-	-
Issued upon exercise of compensation options for cash	751,153	112,673	-	-
Fair value of compensation options exercised (note 8)	-	95,096	-	-
Fair value ascribed to warrants issued on exercise of compensation options (note 6(c))	-	( 81,568)	-	-
Issued for debt conversion (see below)	3,041,361	718,466	-	-
Fair value ascribed to warrants issued in private placements (note 6(c))	-	( 774,031)	-	( 1,691,100)
Tax effect of flow-through shares	-	( 1,231,200)	-	( 471,402)
Share issue costs	-	( 658,691)	-	( 968,182)
Balance, end of the year	<u>103,584,645</u>	<u>\$25,739,681</u>	<u>88,738,714</u>	<u>\$ 23,192,738</u>

Included in shares issued for cash during 2009 was the issuance of common shares for which cash proceeds of \$84,130 were received in 2008.

On April 8, 2010, the TSX Venture exchange approved debt conversion agreements that have been signed by the Company with some of its creditors. The total amount of debt outstanding of \$718,466 has been converted into 3,041,361 common shares of the Company. \$521,049 of the aforementioned debt conversion was with officers, directors, and a company controlled by a director of the Company.

On March 11, 2010, a consultant of the Company exercised 100,000 of his stock options and acquired 100,000 common shares of the Company.

c) Warrants:

In August 2010, the Company issued 5,312,500 warrants as part of a private placement. During 2010, the Company had also issued 375,577 upon exercise of compensation options previously issued as a commission to brokers. 1,692,666 have expired during the year and 328,917 warrants have been exercised (291,667 of which have been used to purchase flow-through shares of the Company). These transactions have increased the total number of outstanding warrants to 23,567,977 as at December 31, 2010, including 499,966 warrants that entitle holders to purchase flow-through common shares of the Company.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

6. CAPITAL STOCK (continued):

c) Warrants (continued):

The following table summarizes warrants that have been issued, exercised or have expired during the years ended December 31, 2010 and 2009:

	Number of warrants	Exercise price	Expiry date
Outstanding, December 31, 2008	1,692,666	\$ 0.44	-
Warrants issued during the year	12,221,684	\$ 0.25	December 29, 2012
	1,170,000	\$ 0.20	April 19, 2013
	208,300	\$ 0.24	April 19, 2013
	1,550,000	\$ 0.20	May 20, 2013
	583,333	\$ 0.24	May 20, 2013
	<u>2,475,000</u>	\$ 0.20	July 23, 2013
Outstanding, December 31, 2009	19,900,983		
Warrants expired during the year	( 825,000)	\$ 2.00	October 14, 2010
	( 200,000)	\$ 0.40	October 2, 2010
	( 534,000)	\$ 0.24	January 20, 2010
	( 133,666)	\$ 0.30	January 20, 2010
Warrants exercised during the year	( 291,667)	\$ 0.24	May 20, 2013
	( 36,750)	\$ 0.25	December 29, 2012
Warrants issued during the year	375,577	\$ 0.25	December 29, 2012
	5,312,500	\$ 0.45	August 25, 2012
Outstanding, December 31, 2010	<u><u>23,567,977</u></u>		

At December 31, 2010, the following warrants were outstanding. The warrants entitle the holders to purchase the stated number of shares at the exercise price on or before the expiry date:

Number of warrants	Exercise price	Expiry date
1,170,000	\$ 0.20	April 19, 2013
208,300	\$ 0.24	April 19, 2013
1,550,000	\$ 0.20	May 20, 2013
291,666	\$ 0.24	May 20, 2013
2,475,000	\$ 0.20	July 23, 2013
12,560,511	\$ 0.25	December 29, 2012
5,312,500	\$ 0.45	August 25, 2012
<u><u>23,567,977</u></u>		

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

6. CAPITAL STOCK (continued):

c) Warrants (continued):

The fair value of each warrant was estimated on the date of measurement. Under Black-Scholes, the warrants issued in 2010 were valued at \$855,599 (2009 - \$1,691,100) and recorded as share purchase warrants using the following assumptions at the measurement date:

	2010	2009
Risk-free interest rate	1.25% – 1.82%	1.57%– 2.48%
Expected life	2 – 3 years	3 – 4 years
Price volatility	100%	100%
Dividend yield	nil	nil

The following table summarizes fair value attributable to warrants that have been issued, exercised or have expired during the years ended December 31, 2010 and 2009:

Balance December 31, 2008	\$	-
Granted		1,691,100
Expired		-
Exercised		-
Balance December 31, 2009		1,691,100
Granted		855,599
Expired		-
Exercised		( 20,940)
Balance December 31, 2010	\$	2,525,759

d) Agent's options:

On August 25, 2010, the Company has issued 1,062,000 agent's options. Each option entitles the agent to purchase a unit consisting of one common share and one half of one common share purchase warrant for \$0.40 up to August 25, 2012. Warrants received upon exercise of the agent's option are exercisable at \$0.45 until August 25, 2012.

On December 29, 2009, there were 3,333,333 agent's options granted. Each option entitles the agent to purchase a unit consisting of one common share and one half of one common share purchase warrant for \$0.15 up to December 29, 2012. Warrants received upon exercise of the agent's option are exercisable for three years at \$0.25. During 2010, 375,577 of these agent's options have been exercised.

The fair value of each agent's option was estimated on the date of grant. Under Black-Scholes, the agent's options issued in 2010 were valued at \$164,581 (2009 - \$422,000) and capitalized to share issue costs using the following assumptions at the measurement date:

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

6. CAPITAL STOCK (continued):

d) Agent's options:	2010	2009
Risk-free interest rate	1.60%	1.57%
Expected life	2 years	3 years
Price volatility	100%	100%
Dividend yield	nil	nil

e) 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 5,250,000 shares (2009 – 3,600,000). The exercise price of the options is \$0.10 for 2,600,000 (expiring on August 5, 2011), \$0.15 for 300,000 (expiring on November 12, 2011), \$0.32 for 300,000 (expiring on November 27, 2011), \$0.27 for 300,000 (expiring July 26, 2012) and \$0.37 for 1,750,000 (expiring August 31, 2015).

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 propriety 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 10,358,465 stock options to be granted under the Plan.

The following summarizes the director, officer and consultant stock options that have been granted, exercised, expired or cancelled during the years ended 2010 and 2009.

	Number	Weighted average price
Balance, December 31, 2008	3,094,230	\$ 0.28
Granted	3,600,000	0.12
Expired or cancelled	(3,094,230)	0.28
Exercised	-	-
Balance, December 31, 2009	3,600,000	\$ 0.12
Granted	2,050,000	0.35
Expired or cancelled	(300,000)	0.10
Exercised	(100,000)	0.10
Balance, December 31, 2010	5,250,000	\$ 0.22

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

6. CAPITAL STOCK (continued):

e) Stock option plan:

The fair value of each option is estimated on the date of grant. Under Black-Scholes, the options issued in 2010 were valued at \$540,400 (2009 - \$227,940) and expensed to loss, using the following assumptions at the measurement date:

	2010	2009
Risk-free interest rate	1.60% - 2.05%	1.12% - 1.47%
Expected life	2 - 5 years	2 years
Price volatility	100%	100%
Dividend yield	nil	nil

7. INCOME TAXES:

a) At December 31, 2010, the Company has non-capital losses of \$4,252,921 that can be used to reduce future taxable income. These losses expire as follows:

2011	\$559,902
2015	494,417
2016	340,546
2017	171,786
2027	293,517
2028	458,265
2029	1,067,753
2030	<u>866,735</u>
	<u>\$4,252,921</u>

As at December 31, 2010 the tax effects of temporary timing differences that give rise to significant components of the future tax asset (liabilities) computed at current rates 28.5% (2009 - 33%), were as follows:

	2010	2009
Non-capital losses carry forward	\$1,140,357	\$1,384,461
Capital assets	13,356	15,465
Share issue costs	315,741	587,800
Mineral property	( 195,058)	1,206,359
Less: Valuation allowance	<u>(1,274,396)</u>	<u>(3,194,085)</u>
Net asset	<u>\$ -</u>	<u>\$ -</u>

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

INCOME TAXES (continued):

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

	2010	2009
Statutory rate applied to loss for the year before income taxes	(\$ 348,159)	(\$318,075)
Increase (decrease) in taxes resulting from:		
Non-deductible stock-based compensation	154,014	75,220
Deductible share issue costs	( 92,732)	( 146,950)
Project evaluation costs	39,857	37,447
Change in valuation allowance through the year	(1,919,689)	194,492
Change in temporary differences during the year	1,919,689	( 171,902)
Tax effect of renunciation of flow-through expenditures	(1,231,200)	( 471,402)
Tax loss not benefited	<u>247,020</u>	<u>329,768</u>
Future income tax (recovery)	<u>(\$1,231,200)</u>	<u>(\$471,402)</u>

The future income tax recovery in each of the years ended December 31, 2010 and 2009 is generated by applying available non-capital losses and other deductible temporary differences not previously recognized to offset any future income tax liability generated through issuance of flow-through shares.

8. CONTRIBUTED SURPLUS:

Contributed surplus is comprised of the following:

	2010	2009
Balance, beginning of the year	\$ 1,157,992	\$ 508,052
Stock-based compensation cost (note 6 (e))	540,400	227,940
Fair value of Agent's compensation options (note 6 (d))	164,581	422,000
Exercise of Agent's compensation options (note 6(b))	( 95,096)	
Exercise of stock options (note 6(b))	<u>( 6,070)</u>	<u>-</u>
Balance, end of the year	<u>\$ 1,761,807</u>	<u>\$1,157,992</u>

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

9. FINANCIAL INSTRUMENTS AND FINANCIAL RISK FACTORS:

**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, advances and accounts payable and accrued liabilities are comparable to their carrying value due to the relatively short period to maturity of these instruments.

The Company's risk exposures and the impact on the Company's financial instruments are summarized below:

**Credit risk**

The Company's credit risk is primarily attributable to cash and receivables included in current assets. The Company has no material concentration of credit risk arising from operations. Cash consists of bank deposits, which have been invested with a Canadian Chartered Bank, from which management believes the risk of loss to be remote. Management believes that credit risk with respect to receivables is minimal.

**Liquidity risk**

The Company's approach to managing liquidity risk is to ensure that it will have sufficient liquidity to meet liabilities when due. As at December 31, 2010, the Company has cash of \$1,214,083 (December 31, 2009 - \$3,965,696) to settle accounts payable and accrued liabilities of \$978,198 (December 31, 2009 - \$1,877,231). The ability of the Company to continue to pursue its exploration activities is dependant on its ability to secure additional equity or other financing. All of the Company's financial liabilities have contractual maturities of less than 30 days and are subject to normal trade terms.

**Market risk**

Market risk is the risk of loss that may arise from changes in market factors such as interest rates and equity prices as identified below:

(a) Interest rate risk - The Company has cash and no interest bearing debt. The Company's current policy is to invest excess cash in investment-grade term deposit certificates issued by its banking institution. The Company periodically monitors the investments it makes and is satisfied with the credit worthiness of its bank.

(b) Price risk - Equity price risk is defined as the potential adverse impact on the Company's earnings due to movements in individual equity prices or general movements in the level of the stock market. The Company currently has no exposure or price risk as it has no investments in equities.

(c) Commodity price risk - the Company is exposed to price risk with respect to commodity prices. Changes in commodity prices will impact the economics of development of the Company's mineral properties. The Company closely monitors commodity prices to determine the appropriate course of action to be taken by the Company. Such movements may influence the future course of direction of the Company; commodity price risk has no impact on the net income (loss) of the Company because it is currently not in production.

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

10. CAPITAL MANAGEMENT:

The Company considers its capital to include components of shareholders' equity.

The Company's objectives in managing its capital are: to maintain adequate levels of funding to support its expenditures arising from the Company's investments; to safeguard the Company's ability to continue as a going concern in order to pursue the exploration of its mineral properties; to maintain a flexible capital structure for its projects for the benefit of its stakeholders; to maintain corporate and administrative functions necessary to support the Company's operations and corporate functions; and to seek out and acquire new projects of merit.

The Company manages its capital structure and makes adjustments to it, based on the funds available to the Company, in order to support the acquisition, exploration and development of mineral properties. The capability of the Company to carry out planned exploration and pay for administrative costs is dependant on its ability to secure additional equity or other financings. The Company will assess properties and seek to acquire properties if it feels there is sufficient geologic or economic potential and if it has adequate financial resources to do so.

The Company's investment policy is to invest excess cash in low risk, highly liquid, short-term interest bearing investments, selected with regards to the expected timing of upcoming expenditures.

Management reviews its capital management approach on an ongoing basis and believes that this approach, given the relative size of the Company, is reasonable.

There were no changes in the Company's approach to capital management during the year ended December 31, 2010. The Company is not subject to externally imposed capital requirements.

11. COMMITMENTS:

- a) 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.
- b) On July 4, 2008, the Company entered into a five-year finder's fee agreement. The Company will pay fees on a downward scale from eight per cent (on the first \$10 million) to three percent (for amounts over \$15 million) on equity financing. In the case of joint venture financing, the fee scale will move from ten per cent (on the first \$300,000) to one and a half percent (for amounts over \$25 million).
- c) On March 10, 2009, the Company entered into a three-year finder's fee agreement. The Company will pay fees on a downward scale from eight per cent (on the first \$10 million) to three percent (for amounts over \$15 million) on equity financing. In the case of joint venture financing, the fee scale will move from ten per cent (on the first \$300,000) to one and a half percent (for amounts over \$25 million).

DARNLEY BAY RESOURCES LIMITED  
(A Development Stage Company)

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2010 AND 2009

COMMITMENTS (continued):

- d) On August 5, 2009, the Company entered into a two year finder's fee agreement. The Company will pay fees on a downward scale from six and a half per cent (on the first \$10 million) to three percent (for amounts over \$15 million) on equity financing. In the case of joint venture financing, the fee scale will move from ten per cent (on the first \$300,000) to one and a half percent (for amounts over \$25 million).
- e) In conjunction with an agency agreement entered into by the Company on December 29, 2009, the agent has been granted a two year first right of refusal to lead manage future financings.
- f) The Company entered into an agreement to lease a field camp in 2011 for minimum rental payments of \$90,000. See note 12.

12. ADVANCES:

Advances have been made by the Company to the Paulatuk Development Corporation ("PDC") for the purposes of a field camp purchase to be made by PDC. Advances are interest free with no specified terms of repayment.

Certain of the advances will be offset against minimum rent payable to PDC as they become due. The minimum rent payable for 2011 amounts to \$90,000 (see note 11(f)).

13. 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 loss.