

**FORTUNA SILVER MINES INC.**

**INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2008**

(Unaudited – Prepared by Management)

(Expressed in thousands of Canadian Dollars)

**UNAUDITED FINANCIAL STATEMENTS:** In accordance with National Instrument 51-102 of the Canadian Securities Administrators, the Company discloses that its auditors have not reviewed the unaudited interim financial statements for the six month period ended June 30, 2008.



FORTUNA SILVER MINES INC.  
INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME  
(Unaudited – Prepared by Management)  
(Expressed in thousands of Canadian Dollars, except for share and per share amounts)

	Three months ended June 30, 2008	Three months ended June 30, 2007	Six months ended June 30, 2008	Six months ended June 30, 2007
Sales	\$ 7,848	\$ 8,797	\$ 14,682	\$ 14,536
Cost of sales (including depletion, depreciation and accretion of \$2,283 and \$2,989 for 2007)	4,972	4,785	9,494	8,810
<b>MINE OPERATING INCOME</b>	<b>2,876</b>	<b>4,012</b>	<b>5,188</b>	<b>5,726</b>
Selling, general and administrative expenses (includes depreciation of \$22 and \$11 for 2007)	1,943	1,460	3,534	2,660
Stock-based compensation (Note 13)	225	113	626	2,423
	2,168	1,573	4,160	5,083
<b>OPERATING INCOME</b>	<b>708</b>	<b>2,439</b>	<b>1,028</b>	<b>643</b>
Interest and other income and expenses	234	336	685	616
Interest and finance expenses	(29)	(41)	(46)	(101)
Net gain on commodity contracts (Note 4)	2,236	-	1,647	-
Loss on disposal of property, plant and equipment	(3)	-	(23)	-
Foreign exchange gain (loss)	416	(702)	427	(546)
	2,854	(407)	2,690	(31)
<b>INCOME BEFORE INCOME TAXES AND NON-CONTROLLING INTEREST</b>	<b>3,562</b>	<b>2,032</b>	<b>3,718</b>	<b>612</b>
Income tax provision	1,155	1,076	1,767	1,414
Non-controlling interest	19	7	75	7
<b>NET INCOME (LOSS) FOR THE PERIOD</b>	<b>2,388</b>	<b>949</b>	<b>1,876</b>	<b>(809)</b>
Other comprehensive loss, net of tax Unrealized (loss) gain on available for sale long-term investments (Note 14)	(256)	(353)	(625)	321
<b>COMPREHENSIVE INCOME (LOSS) FOR THE PERIOD</b>	<b>\$ 2,132</b>	<b>\$ 596</b>	<b>\$ 1,251</b>	<b>\$ (488)</b>
Basic income (loss) per share	\$ 0.03	\$ 0.01	\$ 0.02	\$ (0.01)
Diluted income (loss) per share	\$ 0.03	\$ 0.01	\$ 0.02	\$ -
Basic comprehensive income (loss) per share	\$ 0.02	\$ 0.01	\$ 0.01	\$ (0.01)
Diluted comprehensive income (loss) per share	\$ 0.02	\$ 0.01	\$ 0.01	\$ -
Weighted average number of shares outstanding				
Basic	85,329,901	70,023,703	83,460,052	66,959,041
Diluted	86,559,462	83,260,090	85,636,347	-

(See accompanying Notes)

FORTUNA SILVER MINES INC.  
INTERIM CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
FOR THE SIX MONTHS ENDED JUNE 30, 2008 AND 2007  
(Unaudited – Prepared by Management)  
(Expressed in thousands of Canadian Dollars, except for share amounts)

	Share Capital		Contributed surplus	(Deficit)	Accumulated Other Comprehensive Income	Total Shareholders' Equity
	Shares	Amount				
Balance – December 31, 2006 (audited)	46,587,728	\$ 43,341	\$ 6,085	\$ (8,219)	\$ -	\$ 41,207
Cumulative impact of accounting changes, net of tax	-	-	-	-	449	449
Exercise of options	986,200	1,354	-	-	-	1,354
Exercise of warrants	5,049,638	8,064	-	-	-	8,064
Private placement for cash	18,000,000	34,200	-	-	-	34,200
Private placement commission non-cash transaction	422,300	802	-	-	-	802
Transfer of contributed surplus on exercise of options	-	867	(867)	-	-	-
Stock based compensation	-	-	2,422	-	-	2,422
Issue costs (non-cash amount \$802)	-	(2,487)	-	-	-	(2,487)
(Loss) for the period	-	-	-	(809)	-	(809)
Other comprehensive gain, net of tax	-	-	-	-	321	321
Balance – June 30, 2007	71,045,866	\$ 86,141	\$ 7,640	\$ (9,028)	\$ 770	\$ 85,523

	Share Capital		Contributed Surplus	(Deficit)	Accumulated Other Comprehensive Income	Total Shareholders' Equity
	Shares	Amount				
Balance – December 31, 2007 (audited)	80,977,663	\$ 100,159	\$ 11,770	\$ (11,008)	\$ 144	\$ 101,065
Exercise of options	31,400	38	-	-	-	38
Exercise of warrants	4,322,596	7,997	-	-	-	7,997
Transfer of contributed surplus on exercise of options	-	27	(27)	-	-	-
Stock based compensation	-	-	626	-	-	626
(Loss) for the period	-	-	-	1,876	-	1,876
Other comprehensive (loss), net of tax	-	-	-	-	(625)	(625)
Balance – June 30, 2008	85,331,659	108,221	12,369	(9,132)	(481)	110,977

(See accompanying Notes)

FORTUNA SILVER MINES INC.  
INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited – Prepared by Management)  
(Expressed in thousands of Canadian Dollars)

	Three months ended June 30, 2008	Three months ended June 30, 2007	Six months ended June 30, 2008	Six months ended June 30, 2007
<b>OPERATING ACTIVITIES</b>				
Net income (loss) for the period	\$ 2,388	\$ 947	\$ 1,876	\$ (809)
Items not involving cash				
Depletion and depreciation	1,191	1,525	2,252	2,925
Accretion expense	27	37	53	74
Future income tax	1,436	1,076	1,604	1,414
Stock based compensation	225	113	626	2,422
Unrealized gain on commodity contracts	(2,236)	-	(1,647)	-
Loss on disposal of equipment	3	-	23	-
Foreign exchange gain	(719)	(651)	(61)	(578)
Non-controlling interest	19	-	75	-
Changes in non-cash working capital items				
Realized gain on commodity contract	162	-	313	-
Accounts receivable and prepaid expenses	456	(1,137)	(2,154)	(2,807)
Inventories	64	37	(142)	(88)
Accounts payable	1,121	(455)	(402)	770
Payments from (to) related parties (Note 10)	4	10	16	(1)
<b>Net cash from operating activities</b>	<b>4,141</b>	<b>1,502</b>	<b>2,432</b>	<b>3,322</b>
<b>FINANCING ACTIVITIES</b>				
Proceeds on issuance of common shares	4	4,768	8,035	41,933
Capital lease obligations	(15)	(22)	(129)	(33)
Repayment of debt (Note 11)	-	-	-	(5,730)
<b>Net cash (used in) from financing activities</b>	<b>(11)</b>	<b>4,746</b>	<b>7,906</b>	<b>36,170</b>
<b>INVESTING ACTIVITIES</b>				
Mineral property expenditures	(6,542)	(1,307)	(9,067)	(3,289)
Value added taxes on purchase of property, plant and equipment	(451)	-	(611)	-
Property, plant & equipment expenditures	(930)	(1,166)	(1,305)	(2,564)
Proceeds from disposal of equipment	2	-	10	-
<b>Net cash used in investing activities</b>	<b>(7,921)</b>	<b>(2,473)</b>	<b>(10,973)</b>	<b>(5,853)</b>
<b>(DECREASE) INCREASE IN CASH</b>	<b>(3,791)</b>	<b>3,775</b>	<b>(635)</b>	<b>33,639</b>
Cash and cash equivalents – beginning of period	50,396	31,505	47,240	1,641
<b>CASH AND CASH EQUIVALENTS – END OF PERIOD</b>	<b>\$ 46,605</b>	<b>\$ 35,280</b>	<b>\$ 46,605</b>	<b>\$ 35,280</b>
<b>Supplementary disclosure of cash flow information:</b>				
Cash received for interest	\$ (323)	\$ (365)	\$ (808)	\$ (616)
Cash paid for income taxes	\$ 67	\$ -	\$ 277	\$ -

Non-cash transactions (Note 16)

(See accompanying Notes)

## **FORTUNA SILVER MINES INC.**

### **NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2008**

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

#### **1. Nature and Continuance of Operations**

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

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

#### **2. Significant Accounting Policies**

##### Basis of presentation

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles using the same accounting policies and methods as our most recent annual financial statements except as noted below. These interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements as at December 31, 2007.

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

##### Changes in Accounting Policies

Effective January 1, 2008, the Company adopted the following standards previously issued by the Canadian Accounting Standards Board ("AcSB"). In accordance with the transitional provisions of these standards, the changes were adopted prospectively (if applicable), with no restatement of prior periods.

##### Section 1535 – Capital Disclosures

This Section establishes standards for disclosing information about an entity's capital and how it is managed. Disclosures include what is defined as capital, how it is managed, and whether externally imposed restrictions on capital are present.

##### Section 3031 - Inventories

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

## **FORTUNA SILVER MINES INC.**

### **NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2008**

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

#### Section 3862 – Financial Instruments – Disclosures

This Section, in addition to Section 3863, replaces Section 3861 “Financial Instruments – Disclosure and Presentation” and requires entities to provide disclosure of quantitative and qualitative information in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance; and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and management's objectives, policies and procedures for managing such risks. Entities are required to disclose the measurement basis or bases used, and the criteria used to determine classification for different types of instruments.

#### Section 3863 – Financial Instruments – Presentation

This Section, in addition to Section 3862, replaces Section 3861 “Financial Instruments – Disclosure and Presentation”, and provides guidance on presentation of financial instruments as liabilities vs. equity and when offsetting of financial assets and financial liabilities is appropriate. The adoption of this standard did not have a material impact on the Company's presentation of its financial instruments.

### **3. Financial Instruments**

All financial instruments are recorded initially at estimated fair value on the balance sheet and classified into one of five categories: held for trading, held to maturity, available for sale, loans and receivables and other liabilities.

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

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

### **4. Derivatives**

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

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

FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2008

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

The following Zinc Asian Option contracts were entered into:

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

The following Lead Asian Option contracts were entered into:

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

As at June 30, 2008 the Company had 7 open positions on each of these arrangements.

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

The following Lead Asian Option contracts were entered into:

- 12 Long put options at strike price: USD 2,200/t, for the total of 1,025 tons
- 12 Short call options at strike price: USD 2,750/t, for the total of 1,025 tons
- 12 Long call options at strike price: USD 3,750/t, for the total of 1,025 tons

As at June 30, 2008 the Company had 8 open positions on each of these arrangements.

The following Zinc Forward sale contracts were entered into on a SWAP basis:

- 12 Forward contracts: USD 2,360/t, for the total of 1,700 tons

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

As at June 30, 2008, the Company had 8 open positions on each of these arrangements.

Additionally, the Company will occasionally enter into forward lead and zinc contracts with banks to fix the final settlement price of metal delivered in concentrates (QP hedges), where the final settlement price is yet to be set at a future quotational period according to contract terms.

The estimated fair value of the outstanding derivative contracts of \$2,780 was determined based on using applicable valuation techniques for commodity options and futures with reference to the published market prices for underlying commodities quoted at London Metal Exchange. The change in estimated fair value with respect to the amount recorded at December 31, 2007 has been recorded as a gain on commodity contract of \$1,647 as at June 30, 2008.

**5. Accounts receivable and prepaid expenses**

	June 30, 2008	December 31, 2007
Trade accounts receivable	\$ 3,139	\$ 409
Advances and other receivables	2,488	1,505
Prepaid expenses and deposits	186	137
	<u>\$ 5,813</u>	<u>\$ 2,051</u>



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

FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2008

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

**6. Inventories**

Inventories consist of the following:

	June 30, 2008	December 31, 2007
Ore stock piles	\$ 530	\$ 466
Concentrate stock piles	217	159
Materials and supplies	1,110	1,068
	<u>\$ 1,857</u>	<u>\$ 1,693</u>

**7. Long term investments**

At June 30, 2008 and December 31, 2007 the Company owned 3,706,250 shares of Continuum Resources Ltd. With the adoption of financial instruments standards, the Company measures these investments at fair value (Note 3). The fair value was determined based on published share prices of underlying securities on the active market. On adoption of financial instruments standards, a cumulative adjustment was recorded in other comprehensive income to reflect the change in accounting policy.

	June 30, 2008	December 31, 2007
Fair value	\$ 185	\$ 908
Cost	741	741
Unrealized (loss) gain (cumulative)	<u>\$ (556)</u>	<u>\$ 167</u>

**8. Property, Plant & Equipment**

Property, plant and equipment are comprised of the following:

	June 30, 2008		
	Cost	Accumulated Depreciation	Net book value
Land	\$ 259	\$ -	\$ 259
Machinery & equipment	8,220	1,538	6,682
Buildings	3,056	549	2,507
Furniture & other equipment	1,145	165	980
Vehicles	621	129	492
Equipment under capital lease	1,409	165	1,244
Work in progress	2,090	-	2,090
	<u>\$ 16,800</u>	<u>\$ 2,546</u>	<u>\$ 14,254</u>

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

FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2008

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

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

**9. Mineral Properties**

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

				June 30, 2008	December 31, 2007
	Cost	Depletion	Write-off	Net	Net
Peru - Caylloma	\$ 34,396	\$ 6,291	\$ -	\$ 28,105	\$ 26,268
Mexico – San Jose	32,698	-	-	32,698	26,070
	<u>\$ 67,094</u>	<u>\$ 6,291</u>	<u>\$ -</u>	<u>\$ 60,803</u>	<u>\$ 52,338</u>

Additions to mineral properties are comprised of development and exploration costs capitalized and consist of \$4,053 at Caylloma and \$6,628 at San Jose properties for the six month period ended June 30, 2008. In addition, there was a revision to the estimate for the asset retirement obligation for Caylloma which resulted in a decrease of \$720 to the cost of the mineral property. Included in additions to San Jose mineral properties are depreciation of equipment involved in construction work of \$89 (2007: \$nil), and general and administrative costs to develop the mine of \$652 (2007: \$nil).

**San Jose Project, Mexico**

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

Cuzcatlan has been accounted for as a variable interest entity, as defined in CICA Accounting Guideline 15 “Consolidation of Variable Interest Entities” and has been consolidated from the date of acquisition. A non-controlling interest of \$8,931 has been recorded as at June 30, 2008 (June 30, 2007 - \$5,164).

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

FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2008

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

**10. Related Party Transactions**

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

	Six months ended June 30, 2008	Six months ended June 30, 2007
Mineral property costs – geological fees	\$ -	\$ 45
Consulting fees	15	50
Salaries and wages	13	40
Management fees	508	115

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

At June 30, 2008, due to related parties consists of \$30 (December 31, 2007 - \$14) owing to an officer and to companies with a common director. These amounts were incurred as a result of shared administrative costs. These amounts are unsecured, non-interest bearing and payable in the normal course of business.

**11. Loans and leases**

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

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

*Obligations under capital lease*

The following is a schedule of the Company's capital lease obligations. These are related to the acquisition of mining equipment, vehicles and buildings.

	Interest Rate	Maturity Date	June 30, 2008	December 31, 2007
Banco Interamericano de Finanzas	8.50%	2009	\$ 63	\$ 82
Scotiabank	9.29%	2009	22	28
Scotiabank	8.20%	2009	199	252
Scotiabank	8.66%	2010	288	335
Scotiabank	8.34%	2010	32	37
Scotiabank	8.20%	2010	514	138
Present value of lease payments			\$ 1,118	\$ 872
Less current amount			(841)	(439)
			<u>\$ 277</u>	<u>\$ 433</u>

**FORTUNA SILVER MINES INC.**

**NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2008**

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

**12. Asset Retirement Obligation**

The Company has recorded an asset retirement obligation of \$1,249 as of June 30, 2008 consisting of accretion of the previously recorded asset retirement obligation of \$1,916 as of December 31, 2007 by \$53 and a reduction in the estimated amount of the asset retirement obligation of \$720. The accretion expense was calculated over the year using a rate of 9%. The initial amount was based on an estimate prepared by an independent third party at the time of acquisition as to the cost of reclamation associated with the Caylloma property. The Company has reviewed its reclamation obligations at the property in light of changing regulations and on the basis of further data in respect of the mine life and has made a reduction in the estimated amount of the asset retirement obligation of \$720.

In view of the uncertainties concerning environmental reclamation, the ultimate cost of reclamation activities could differ materially from the estimated amount recorded. The estimate of the Company's asset retirement obligation relating to the Caylloma mine is subject to change based on amendments to laws and regulations and as new information regarding the Company's operations becomes available.

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

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

FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2008

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

**13. Share Capital**

a) Authorized: Unlimited common shares without par value

	Number of shares	Amount
Balance - September 30, 2005	20,083,465	\$ 12,164
Exercise of options	650,000	424
Exercise of warrants	6,124,631	5,601
Private placement for cash	16,700,000	22,050
Private placement commission non-cash transaction	760,261	1,140
Property acquisition non-cash transaction	1,897,621	2,714
Property finders fee non-cash transaction	50,000	68
Property acquisition non-cash transaction	168,417	285
Loan fee	153,333	276
Transfer of contributed surplus on exercise of options	-	214
Less issue costs (non-cash amount \$1,140)	-	(1,595)
Balance - December 31, 2006	46,587,728	43,341
Exercise of options	1,753,600	1,957
Exercise of warrants	14,214,035	21,057
Private placement for cash	18,000,000	34,200
Private placement commission non-cash transaction (Note 16)	422,300	802
Transfer of contributed surplus on exercise of options	-	1,289
Less issue costs (non-cash amount \$802)	-	(2,487)
Balance - December 31, 2007	80,977,663	100,159
Exercise of options	31,400	38
Exercise of warrants	4,322,596	7,997
Transfer of contributed surplus on exercise of options	-	27
Balance - June 30, 2008	<u>85,331,659</u>	<u>\$ 108,221</u>

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

FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2008

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

**13. Share Capital (continued)**

## b) Stock Options

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

	Six months ended June 30, 2008		Year ended December 31, 2007	
	Number of Options	Weighted Average Exercised Price	Number of Options	Weighted Average Exercised Price
Outstanding, beginning of period	6,686,400	\$ 2.24	3,765,000	\$ 1.62
Granted	250,000	2.52	4,355,000	2.82
Exercised	(31,400)	1.22	(1,321,100)	1.48
Expired/cancelled	-	-	(112,500)	2.56
Outstanding, end of period	<u>6,905,000</u>	<u>\$ 2.41</u>	<u>6,686,400</u>	<u>\$ 2.24</u>

The following stock options were outstanding and exercisable at June 30, 2008:

Number of options	Exercise Price \$	Expiry Date
29,000	0.37	December 2, 2009
30,000	0.80	July 24, 2010
270,000	1.35	February 5, 2016
451,000	2.29	March 30, 2016
60,000	1.75	May 8, 2016
200,000	1.75	May 22, 2016
280,000	1.55	July 5, 2016
860,000	1.66	July 10, 2016
225,000	1.61	September 13, 2016
20,000	1.90	November 20, 2016
50,000	1.96	November 23, 2016
1,385,000	2.22	January 11, 2017
80,000	2.75	February 6, 2017
15,000	3.09	April 22, 2017
50,000	3.10	May 31, 2017
50,000	3.10	June 17, 2017
50,000	3.05	June 27, 2017
2,025,000	3.22	July 2, 2017
250,000	2.97	September 23, 2017
250,000	2.82	October 9, 2010
25,000	3.10	October 24, 2017
250,000	2.52	February 5, 2018
<u>6,905,000</u>		

6,655,500 options have vested as at June 30, 2008. The average remaining life of the outstanding options at June 30, 2008 is 8.3 years.

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

**13. Share Capital (continued)**

## c) Warrants

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

	Six months ended June 30, 2008		Year ended December 31, 2007	
	Number of Warrants	Weighted Average Exercise Price	Number of Warrants	Weighted Average Exercise Price
Outstanding, beginning of period	16,479,375	\$ 1.89	20,566,185	\$ 1.23
Issued	-	-	10,559,725	2.30
Exercised	(4,322,596)	1.85	(14,646,535)	1.44
Outstanding, end of period	12,156,779	\$ 1.90	16,479,375	\$ 1.89

The following share purchase warrants were outstanding at June 30, 2008:

Number of warrants	Exercise Price \$	Expiry Date
862,117	0.345	June 27, 2010
1,613,238	0.345	November 17, 2010
960,969 *	2.300	July 11, 2008
8,720,455 **	2.300	July 11, 2008
<u>12,156,779</u>		

\* These 960,969 warrants expired unexercised on July 11, 2008

\*\* Of these warrants, 132,455 expired unexercised on July 11, 2008. Subsequent to the quarter end, the expiry date for the remaining 8,588,000 was extended to July 11, 2009.

## d) Stock-Based Compensation

The Company uses the fair value based method of accounting for share options granted to consultants, directors, officers and employees. The non-cash compensation charge of \$626 recognized for the six month period ended June 30, 2008 (six month period ended June 30, 2007: \$2,423) is associated with the granting of options to consultants, officer and employee. These compensation charges have been determined under the fair value method using the Black-Scholes option pricing model with the following assumptions:

	Six month period ended June 30, 2008	Six month period ended June 30, 2007
Risk-free interest rate	3.78% - 4.58%	4.03% - 4.67%
Expected stock price volatility	59.0% - 72.8%	59.0% - 68.0%
Expected term in years	3, 5 & 10	5 & 10
Expected dividend yield	0%	0%

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

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**14. Accumulated other comprehensive income**

	<u>June 30, 2008</u>
Balance - December 31, 2007	\$ 144
Unrealized (loss) on available-for-sale long term investment, net of tax	<u>(625)</u>
Balance - June 30, 2008	<u>\$ (481)</u>

**15. Segmented Information**

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

	<u>Canada</u>	<u>Peru</u>	<u>Mexico</u>	<u>Other</u>	<u>Total</u>
<b>Six months ended June 30, 2008</b>					
Revenue	\$ -	\$ 14,682	\$ -	\$ -	\$ 14,682
Operating (loss) income	\$ (2,000)	\$ 3,037	\$ -	\$ (9)	\$ 1,028
<b>Six months ended June 30, 2007</b>					
Revenue	\$ -	\$ 14,536	\$ -	\$ -	\$ 14,536
Operating (loss) income	\$ (3,106)	\$ 3,752	\$ -	\$ (3)	\$ 643
<b>As at June 30, 2008</b>					
Property, plant & equipment	\$ 6	\$ 9,718	\$ 4,527	\$ 3	\$ 14,254
Total assets	\$ 39,611	\$ 52,335	\$ 44,611	\$ 1,026	\$ 137,583
<b>As at December 31, 2007</b>					
Property, plant & equipment	\$ 7	\$ 9,252	\$ 4,407	\$ 3	\$ 13,669
Total assets	\$ 40,273	\$ 49,297	\$ 34,155	\$ 721	\$ 124,446



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**16. Supplementary Disclosure of Non-cash Transactions**

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

The following non-cash transactions occurred:

	Six months ended June 30, 2008	
	<u>Number of shares</u>	<u>Amount</u>
Fair value of options exercised	-	27

  

	Six months ended June 30, 2007	
	<u>Number of shares</u>	<u>Amount</u>
Shares issued for commission on private placement	422,300	\$ 802
Purchase of equipment on a deferred payment plan	-	1,827

**17. Commitments**

On May 6, 2008, after renegotiating the existing option agreement on the Monte Alban II concession surrounding the San Jose project, Compañia Minera Cuzcatlan SA closed the purchase of a direct 100% interest on this property. The purchase price consisted of US\$1,100 paid upon closing, and an additional US\$800 payment due by May 2012.

The Company has a contract with one customer who purchases the full production of the year 2008 from the Company's operating Caylloma mine. Under the contract, the Company is committed to supply 8,700 wet metric tons of lead concentrate and 17,000 wet metric tons of zinc concentrate.

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

**18. Management of capital risk**

The Company's objectives when managing capital are to provide shareholder returns through maximization of the profitable growth of the business and to maintain a degree of financial flexibility relevant to the underlying operating and metal price risks while safeguarding the Company's ability to continue as a going concern.

The Company is not subject to externally imposed capital requirements.

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**19. Management of financial risk**

The Company's financial instruments are exposed to certain financial risks, including currency risk, credit risk, liquidity risk, interest risk and price risk.

**(a) Currency risk**

The Company is exposed to the financial risk related to the fluctuation of foreign exchange rates. The Company operates in Canada, Peru, Mexico and Barbados and a portion of its expenses are incurred in US dollars, Nuevo Soles, and Mexican Pesos. A significant change in the currency exchange rates between the Canadian dollar relative to the other currencies could have an effect on the Company's results of operations, financial position or cash flows. The Company has not hedged its exposure to currency fluctuations.

At June 30, 2008, the Company is exposed to currency risk through the following assets and liabilities denominated in US dollars, Nuevo Soles and Mexican Pesos (all amounts are expressed in thousands of US dollars, thousands of Nuevo Soles or thousands of Mexican Pesos):

	June 30, 2008		
	US Dollars	Nuevo Soles	Mexican Pesos
Cash and cash equivalents	6,950	173	3,351
Derivatives	1,426	-	-
Accounts receivable	3,106	7,970	41,624
Accounts payable and accrued liabilities	(1,221)	(6,327)	(19,689)
Obligations under capital lease	(1,106)	-	-

Based on the above net exposures as at June 30, 2008, and assuming that all other variables remain constant, a 10% depreciation or appreciation of the Canadian dollar against the US dollar would result in an increase/decrease of \$926 in the Company's net earnings. Likewise, a 10% depreciation or appreciation of the Canadian dollar against the Nuevo Soles would result in an increase/decrease of \$62 in the Company's net earnings and a 10% depreciation or appreciation of the Canadian dollar against the Mexican Pesos would result in an increase/decrease of \$249 in the Company's net earnings.

**(b) Credit risk**

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its contractual obligations. The Company's cash equivalents are held through large Canadian and international financial institutions. These investments mature at various dates over the current operating period. All of the Company's accounts receivables are held with a large international metals trading company.

**FORTUNA SILVER MINES INC.**

**NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2008**

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**19. Management of financial risk continued**

(c) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company manages liquidity risk through the management of its capital structure and financial leverage as outlined in Note 18 to the unaudited consolidated financial statements. Accounts payable and accrued liabilities, amounts due to related parties and the current portion of obligations under capital lease are due within the current operating period.

(d) Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The risk that the Company will realize a loss as a result of a decline in the fair value of the amounts in investments with maturities of 90 days or less included in cash and cash equivalents is limited because these investments, although available for sale, are generally held to maturity.

(e) Price risk

The Company is exposed to metals price risk with respect to silver, gold, zinc, and lead sold through its mineral concentrate products. The Company mitigates this risk by implementing price protection programs for some of its zinc and lead production through the use of derivative instruments. As a matter of policy the Company does not hedge its silver production.

**20. Subsequent Events**

(a) Share Purchase Warrants

Subsequent to the quarter end, the expiry date of 8,588,000 warrants was extended to July 11, 2009. An additional 1,093,424 warrants expired unexercised.

(b) San Jose Silver-Gold Project

The Company and Continuum Resources Ltd. have issued a news release dated August 14, 2008 announcing that an agreement has been reached whereby Fortuna will acquire (the "Acquisition") all of the issued and outstanding securities of Continuum. The shares of both companies are listed on the TSX Venture Exchange.

The companies currently hold jointly the San Jose Project in Mexico (Fortuna 76%; Continuum 24%). As a result of the Acquisition, Fortuna will own 100% of the Project, thus strengthening its position in that country.

Continuum has 124,052,503 shares outstanding, and Fortuna will issue to the Continuum shareholders a total of 7.0 million shares, which is an exchange ratio of approximately 0.0564 of a share of Fortuna for every one Continuum share held. Stock options in Continuum held by non-insiders totaling 285,000 shares will be converted to options to purchase Fortuna shares, at the same ratio. No other rights to purchase Continuum shares will be outstanding at closing of the Acquisition.

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The Acquisition is subject to regulatory and other approvals on behalf of both companies, and the recently announced private placement financing of Continuum has been cancelled. There will be no change of control or management of Fortuna.

**21. Comparative Figures**

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