



## **FINANCIAL REVIEW**

**First Quarter ended December 31, 2005**

**FORTUNA SILVER MINES INC.**  
**(Formerly Fortuna Ventures Inc.)**  
(An Exploration Stage Company)

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005  
(Unaudited – Prepared by Management)

(Expressed in 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 financial statements for the period ended December 31, 2005.

**FORTUNA SILVER MINES INC.**  
**(Formerly Fortuna Ventures Inc.)**  
**(An Exploration Stage Company)**  
**INTERIM CONSOLIDATED BALANCE SHEETS**  
**AS AT DECEMBER 31, 2005**  
**(Unaudited - Prepared by Management)**  
**(Expressed in Canadian Dollars)**

	December 31, 2005	September 30, 2005
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash and equivalents	\$ 4,165,782	\$ 5,850,257
GST and value-added taxes receivable	139,725	39,730
Advances and other receivables	646	215
Prepaid expenses and deposits	57,938	41,410
Due from related parties (Note 5)	5,553	-
	4,369,644	5,931,612
<b>PLANT &amp; EQUIPMENT (Note 3)</b>	130,173	21,534
<b>MINERAL PROPERTIES (Note 3)</b>	18,747,606	18,187,993
<b>INVESTMENTS</b>	1,000,000	-
	<b>\$ 24,247,423</b>	<b>\$ 24,141,139</b>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Accounts payable and accrued liabilities (Note 5)	\$ 651,167	\$ 870,663
Due to related parties (Note 5)	40,955	8,925
Notes payable (Note 3 & 4)	5,270,850	5,270,850
	5,962,972	6,150,438
Asset retirement obligations - Note 9	1,578,441	1,578,441
Future income tax liability (Note 3)	1,207,149	1,207,149
	8,748,562	8,936,028
<b>SHAREHOLDERS' EQUITY</b>		
<b>CAPITAL STOCK (Note 6)</b>	17,745,137	12,163,851
<b>SHARE SUBSCRIPTIONS</b>	-	2,030,888
<b>OBLIGATION TO ISSUE SHARES AND WARRANTS</b>	-	4,584,954
<b>CONTRIBUTED SURPLUS</b>	2,240,933	296,313
<b>DEFICIT</b>	(4,487,209)	(3,870,895)
	15,498,861	15,205,111
	<b>\$ 24,247,423</b>	<b>\$ 24,141,139</b>

APPROVED BY THE DIRECTORS:

\_\_\_\_\_  
*“signed”*  
 Jorge Ganoza Duran, Director

\_\_\_\_\_  
*“signed”*  
 Simon Ridgway, Director

**FORTUNA SILVER MINES INC.**  
**(Formerly Fortuna Ventures Inc.)**  
**(An Exploration Stage Company)**  
**INTERIM CONSOLIDATED STATEMENTS OF DEFICIT**  
**FOR THE THREE MONTH PERIOD ENDED DECEMBER 31, 2005**  
**(Unaudited - Prepared by Management)**  
**(Expressed in Canadian Dollars)**

	Three Month Period Ended December 31,	
	2005	2004
<b>DEFICIT - BEGINNING OF PERIOD</b>	\$ (3,870,895)	\$ (3,265,262)
Net loss for the period	(616,314)	(105,510)
<b>DEFICIT - END OF PERIOD</b>	<b>\$ (4,487,209)</b>	<b>\$ (3,370,772)</b>

**FORTUNA SILVER MINES INC.**  
**(An Exploration Stage Company)**  
**INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS**  
**FOR THE THREE MONTH PERIOD ENDED DECEMBER 31, 2005**  
**(Unaudited - Prepared by Management)**  
**(Expressed in Canadian Dollars)**

	Three Month Period Ended December 31,	
	2005	2004
<b>REVENUE</b>	\$ 18,464	\$ -
<b>EXPENSES</b>		
Amortization	1,589	-
Bank charges and interest	622	-
Consulting	77,653	4,500
Foreign currency exchange	16,082	-
Accounting & Legal	1,933	3,520
Management fees	20,800	2,630
Non cash compensation charge (Note 6)	82,225	79,646
Office and miscellaneous	9,337	955
Public relations	310,108	6,037
Regulatory and stock exchange fees	17,073	2,335
Rent and utilities	2,084	-
Salaries and wages	29,980	-
Telephone and fax	3,512	-
Travel and accommodation	22,270	5,887
	<u>595,267</u>	<u>105,510</u>
<b>LOSS BEFORE OTHER ITEMS</b>	<u>(576,803)</u>	<u>\$ (105,510)</u>
Write-off of deferred exploration costs	(39,511)	-
<b>NET LOSS FOR THE PERIOD</b>	<u>\$ (616,314)</u>	<u>\$ (105,510)</u>
<b>LOSS PER SHARE</b>	<u>\$ (0.03)</u>	<u>\$ (0.02)</u>
<b>Weighted average number of shares outstanding</b>	<u>23,979,559</u>	<u>6,453,000</u>

**FORTUNA SILVER MINES INC.**  
**(Formerly Fortuna Ventures Inc.)**  
**(An Exploration Stage Company)**  
**INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE THREE MONTHS ENDED DECEMBER 31, 2005**  
**(Unaudited - Prepared by Management)**  
**(Expressed in Canadian Dollars)**

	Three Month Period Ended December 31,	
	2005	2004
<b>OPERATING ACTIVITIES</b>		
Net loss for the period	\$ (616,314)	\$ (105,510)
Items not involving cash		
Amortization	1,589	-
Write-off of deferred exploration costs	39,511	-
Stock based compensation charge	82,225	79,646
	<u>(492,988)</u>	<u>(25,864)</u>
Changes in non-cash working capital items	(336,450)	(13,449)
	<u>(829,438)</u>	<u>(39,313)</u>
<b>FINANCING ACTIVITIES</b>		
Proceeds on issuance of common shares	827,839	-
Due from related parties	(5,553)	-
Due to related parties	32,030	-
	<u>854,316</u>	<u>-</u>
<b>INVESTING ACTIVITIES</b>		
Deferred exploration costs	(599,125)	(85,849)
Longterm investment	(1,000,000)	
Purchase of plant & equipment	(110,228)	-
	<u>(1,709,353)</u>	<u>(85,849)</u>
<b>INCREASE (DECREASE) IN CASH</b>	(1,684,475)	(125,162)
Cash - beginning of period	5,850,257	396,321
<b>CASH - END OF PERIOD</b>	<u>\$ 4,165,782</u>	<u>\$ 271,159</u>
Supplementary disclosure of cash flow information:		
Cash paid for interest	<u>\$ -</u>	<u>\$ -</u>
Cash paid for income taxes	<u>\$ -</u>	<u>\$ -</u>
Non-cash Transactions - Note 8		

**FORTUNA SILVER MINES INC.**  
**(Formerly Fortuna Ventures Inc.)**  
**(An Exploration Stage Company)**  
**INTERIM CONSOLIDATED SCHEDULE OF DEFERRED EXPLORATION COSTS**  
**FOR THE THREE MONTHS ENDED DECEMBER 31, 2005**  
**(Unaudited - Prepared by Management)**  
**(Expressed in Canadian Dollars)**

	<u>General Exploration</u>	<u>Guatemala El Tambor</u>	<u>Peru Caylloma</u>	<u>Mexico San Jose</u>	<u>Period Ended Dec. 31, 2005</u>	<u>Year Ended Sept. 30, 2005</u>
<b><u>ACQUISITION COSTS</u></b>						
BALANCE - BEGINNING OF PERIOD	\$ -	\$ -	\$ 12,772,059	\$ -	\$ 12,772,059	\$ 3,457
Acquired mineral rights						
Shares	-	-	-	-	-	4,584,954
Cash	-	-	-	-	-	8,187,105
	-	-	-	-	-	12,772,059
BALANCE - END OF PERIOD	-	-	12,772,059	-	12,772,059	12,775,516
<b><u>DEFERRED EXPLORATION COSTS</u></b>						
BALANCE - BEGINNING OF PERIOD	\$ 8,471	\$ -	\$ 689,682	\$ -	\$ 698,153	\$ 84,229
Automobile	-	2,250	31,675	-	33,925	39,472
Camp, equipment and supplies	-	76	18,742	-	18,818	20,594
Drafting, maps and printing	-	-	2,595	-	2,595	-
Drilling	-	-	89,521	-	89,521	42,315
Exploration administration	-	192	53,581	-	53,773	29,903
Environmental	-	-	5,386	-	5,386	-
Geochemistry	-	-	54,429	-	54,429	8,568
Geological consulting	1,772	3,199	22,850	4,522	32,342	151,017
Other consulting	-	-	64,820	-	64,820	189,428
Legal and accounting	-	9,269	12,489	-	21,758	23,094
Licenses, rights and taxes	-	9,568	3,710	-	13,278	17,561
Materials	-	-	-	-	-	1,273
Maintenance	-	519	14,209	-	14,728	7,906
Miscellaneous	-	696	3,135	-	3,831	2,192
Medical expenses	-	176	1,993	-	2,169	5,807
Geological research	-	-	-	-	-	37,420
Rent and utilities	-	631	24,223	-	24,855	18,358
Rental equipment	-	7,380	-	-	7,380	9,766
Salaries and wages	-	4,920	119,495	-	124,415	94,927
Shipping	-	-	3,746	-	3,746	876
Telephone and communications	-	635	8,884	8	9,526	15,429
Travel and accommodation	-	-	16,924	905	17,829	77,218
	1,772	39,511	552,407	5,434	599,124	793,124
BALANCE - END OF PERIOD	10,243	39,511	1,242,089	5,434	1,297,277	877,353
<b><u>PLANT &amp; EQUIPMENT ACQUISITION</u></b>						
BALANCE - BEGINNING OF PERIOD	-	-	4,717,781	-	4,717,781	-
Plant & Equipment acquired on the acquisition of subsidiary - Note 3	-	-	-	-	-	4,708,283
Equipment acquisitions	-	-	-	-	-	9,498
BALANCE - END OF PERIOD	-	-	4,717,781	-	4,717,781	4,717,781
Write-off Exploration Costs	-	(39,511)	-	-	(39,511)	(182,657)
<b>BALANCE - END OF PERIOD</b>	<b>\$ 10,243</b>	<b>\$ -</b>	<b>\$ 18,731,929</b>	<b>\$ 5,434</b>	<b>\$ 18,747,606</b>	<b>\$ 18,187,993</b>

**Fortuna Silver Mines Inc.****(Formerly Fortuna Ventures Inc.)**

Notes to the Interim Consolidated Financial Statements

(Unaudited – Prepared by Management)

Three Months Ended December 31, 2005

**1. Nature and Continuance of Operations**

On June 28, 2005 Fortuna Silver Mines Inc. (the “Company”) changed its name from Fortuna Ventures Inc. The consolidated financial statements contained herein include the accounts of the Company and its wholly-owned subsidiaries located in Guatemala and Peru.

The Company is in the business of acquiring, exploring and developing mineral resource properties and is presently in the process of exploring and developing its mineral properties in Peru and Mexico. The Company has determined that the Caylloma properties in Peru contain reserves that it expects to be economically recoverable, however, the recoverability of these capitalized costs is dependant upon the ability of the Company to obtain the necessary financing to complete their development and upon future profitable production. The Company has not yet determined whether its other properties contain reserves that are economically recoverable.

The interim period consolidated financial statements have been prepared by the Company in accordance with Canadian generally accepted accounting principles. All financial summaries included are presented on a comparative and consistent basis showing the figures for the corresponding period in the preceding year. The preparation of financial data is based on accounting principles and practices consistent with those used in the preparation of the annual financial statements. Certain information and footnote disclosure normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These interim period statements should be read together with the audited financial statements and the accompanying notes included in the Company’s latest annual report. In the opinion of the Company, its unaudited interim consolidated financial statements contain all adjustment necessary in order to present a fair statement of the results of the interim periods presented.

**2. Significant Accounting Policies**

The interim consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles. Due to precise determination of many assets and liabilities is dependent upon future events, the preparation of financial statements for a period necessarily involves the use of estimates, which have been made using careful judgment. Actual results may differ from these estimates.

**a) Cash and equivalents**

Cash and cash equivalents include highly liquid investments with original maturities of three months or less.

**b) Mineral Properties**

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

**Fortuna Silver Mines Inc.**

**(Formerly Fortuna Ventures Inc.)**

Notes to the Interim Consolidated Financial Statements

(Unaudited – Prepared by Management)

Three Months Ended December 31, 2005 – Page 2

**2. Significant Accounting Policies – (cont'd)**

b) Mineral Properties (cont'd)

The Company is in the process of exploring and developing its mineral properties. Management reviews the carrying value of mineral properties on a periodic basis and will recognize impairment in value based upon current exploration results, the prospect of further work being carried out by the Company, the assessment of future probability of profitable revenues from the property or from the sale of the property. Amounts shown for properties represent costs incurred net of write-downs and recoveries, and are not intended to represent present or future values.

Environmental expenditures that relate to current operations are expensed or capitalized as appropriate. Expenditures that relate to an existing condition caused by past operations and which do not contribute to current or future revenue generation are expensed. Liabilities are recorded when environmental assessments and/or remedial efforts are probable, and the costs can be reasonably estimated. Generally, the timing of these accruals coincides with the earlier of completion of a feasibility study or the Company's commitment to a plan of action based on the then known facts.

c) Basic and Diluted Loss Per Share

Basic loss per share ("LPS") is calculated by dividing loss applicable to common shareholders by the weighted average number of common shares outstanding for the year. Diluted LPS reflects the potential dilution that could occur if potentially dilutive securities are exercised or converted to common stock. Due to the losses, potentially dilutive securities were excluded from the calculation of diluted LPS, as they were anti-dilutive. Therefore, there is no difference in the calculation of basic and diluted LPS.

d) Stock-based Compensation

Effective for fiscal years commencing on or after January 1, 2004, Canadian generally accepted accounting principles require the fair value of all share purchase options granted on or after fiscal years commencing on or after January 1, 2002 to be expensed over their vesting period with a corresponding increase to contributed surplus. Upon exercise of share purchase options, the consideration paid by the option holder, together with the amount previously recognized in contributed surplus, is recorded as an increase to share capital. The Company had not granted any share purchase options prior to October 1, 2004 and accordingly this change in policy has no effect on prior year's operations

e) Asset Retirement Obligations

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

**Fortuna Silver Mines Inc.****(Formerly Fortuna Ventures Inc.)**

Notes to the Interim Consolidated Financial Statements

(Unaudited – Prepared by Management)

Three Months Ended December 31, 2005 – Page 3

**3. Acquisition of Caylloma Silver Mine**

On June 27, 2005 the Company completed the acquisition of the Caylloma Silver Mine located in southern Peru, by acquiring 100% of the outstanding common shares of Minera Bateas S.A.C. (Bateas). Bateas was incorporated in Peru on March 23, 2005 to facilitate the sale to the Company and its assets consist of mining rights to properties located in southern Peru and other property and equipment located on the properties. The purchase price is US\$7,550,000 and the issue of shares and share purchase warrants up to 10.803% of the fully diluted capital of the Company until such time as the Company subsequently completes equity financing of \$10 million. The Company also paid a \$220,000 finder's fee in connection with the transaction. The Company completed the equity financing and issued the required number of shares and share purchase warrants. This acquisition has been accounted for using the purchase method of accounting.

## Net assets acquired, at fair value

Property, plant and equipment	\$ 4,708,284
Mineral rights	12,772,059
Less: asset retirement obligations	(1,578,440)
Less: future tax liability	<u>(1,207,149)</u>
	<u>\$ 14,694,754</u>

## Consideration

Cash and acquisition costs	\$ 641,018
Shares issued on acquisition date – 574,744 at \$0.345 per share	198,287
Fair value of share purchase warrants issued on acquisition date	69,000
Convertible note payable of US\$2,950,000	3,643,545
Note payable of US\$4,500,000	5,557,950
Shares issued on completion of equity financing 1,897,621 at \$1.43 per share	2,713,598
Fair value of share purchase warrants issued on completion of equity financing	<u>1,871,356</u>
	<u>\$ 14,694,754</u>

**Fortuna Silver Mines Inc.****(Formerly Fortuna Ventures Inc.)**

Notes to the Interim Consolidated Financial Statements

(Unaudited – Prepared by Management)

Three Months Ended December 31, 2005 – Page 4

**3. Acquisition of Caylloma Silver Mine – (cont'd)**

The fair value of the share purchase warrants was determined using the Black-Scholes option pricing model using the following assumptions:

	Issued June 27, <u>2005</u>	Issued November 17, <u>2005</u>
Expected dividend yield	0.0%	0.0%
Expected volatility	34.2%	93.8%
Risk-free interest rate	3.75%	3.6%
Expected term in years	2 years	2 years

**4. Note Payable**

	Three months ended December 31, <u>2005</u>	<u>2004</u>
Note payable – US\$4,500,000, secured by the shares of Bateas, non-interest bearing and due on June 27, 2006	\$ <u>5,270,850</u>	\$ <u>                    -</u>

**5. Related Party Transactions**

The Company incurred charges with companies having a common director or officer as follows:

	Three Month Period Ending December 31,	
	<u>2005</u>	<u>2004</u>
Deferred exploration costs – geological fees	\$ 11,930	\$ -
Consulting fees	\$ 22,649	\$ 27,000
Salaries and wages	\$ 6,884	\$ -
Management fees	\$ 20,800	\$ 2,630

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

At December 31, 2005, accounts payable and accrued liabilities included \$491 (Sept 2005: \$181,036) due to directors of the Company and accounts receivable included \$430 (Sept 2005: \$215) due from a director of the Company.

At December 31, 2005, due to related parties consists of amounts owing to a company with a common director which were incurred as a result of shared administrative costs. This amount is unsecured, non-interest bearing and payable in the normal course of business.

**Fortuna Silver Mines Inc.**  
**(Formerly Fortuna Ventures Inc.)**  
Notes to the Interim Consolidated Financial Statements  
(Unaudited – Prepared by Management)  
Three Months Ended December 31, 2005 – Page 5

**6. Capital Stock**

	<u>Number of shares</u>	<u>Price per share \$</u>	<u>Amount</u>
Authorized			
Unlimited common shares without par value			
Issued			
Balance, September 30, 2004	6,452,691		\$ 3,697,482
Cancellation of shares for debt	(4,000)	0.25	(1,000)
Cancellation of escrow shares	(87,470)	0.07	(6,123)
Private placement for cash	1,500,000	0.70	1,050,000
Private placement for cash	9,600,000	0.75	7,200,000
Property acquisition	574,744	0.35	198,287
Exercise of options	47,500	0.37	17,575
Exercise of warrants	2,000,000	0.30	600,000
Transfer of contributed surplus on exercise of options	47,500	0.16	7,530
	<u>13,630,774</u>		<u>9,066,269</u>
Less issue costs			<u>(599,900)</u>
Balance, September 30, 2005	<u>20,083,465</u>		<u>\$ 12,163,851</u>
Exercise of options	25,000	0.37	9,250
Exercise of options	10,000	0.72	7,200
Private placement for cash	4,000,000	0.75	3,000,000
Property acquisition	1,897,621	1.43	2,713,598
Transfer of contributed surplus on exercise of options	25,000	0.16	3,962
Transfer of contributed surplus on exercise of options	10,000	0.50	5,000
Less issue costs			<u>(157,723)</u>
Balance, December 31, 2005	<u><u>26,016,086</u></u>		<u><u>\$ 17,745,137</u></u>

**Stock Options**

The Company has established a formal stock option plan in accordance with the policies of the TSX-V under which it is authorized to grant options up to 10% of its outstanding shares to officers, directors, employees and consultants. The exercise price of each option equals the market price of the Company's stock as calculated on the date of grant. Upon the Company becoming a Tier 1 issuer on the TSX Venture Exchange on January 13, 2006, the options are for a maximum term of ten years.

**Fortuna Silver Mines Inc.****(Formerly Fortuna Ventures Inc.)**

Notes to the Interim Consolidated Financial Statements

(Unaudited – Prepared by Management)

Three Months Ended December 31, 2005 – Page 6

**6. Capital Stock (cont'd)****Stock Options (cont'd)**

The following stock options were outstanding at December 31, 2005:

<u>Number of shares</u>	<u>Exercise Price \$</u>	<u>Expiry Date</u>
175,000	0.80	July 24, 2006
430,000	0.37	December 2, 2009
140,000	0.72	July 13, 2010
80,000	0.80	July 24, 2010
85,000	1.35	November 17, 2010
<u>910,000</u>		

**Warrants**

The following share purchase warrants were outstanding at December 31, 2005:

<u>Number of shares</u>	<u>Exercise Price \$</u>	<u>Expiry Date</u>
1,500,000	0.75	June 27, 2006
862,117	0.345	June 28, 2007 *
1,613,238	0.345	November 17, 2007 *
9,600,000	1.00	September 26, 2007
1,152,000	0.80	September 26, 2007
231,056	0.80	October 6, 2007
4,000,000	1.00	October 6, 2007
<u>18,958,411</u>		

\* Upon the Company becoming a Tier 1 issuer on the TSX Venture Exchange on January 13, 2006, these warrants were automatically extended by three years.

**Escrow Securities**

All of the 87,470 shares held in escrow were cancelled by the regulatory authorities on March 9, 2005. The issued share capital reflects the cancellation of these shares.

As at June 1, 2005, there were placed in escrow 495,422 common shares and warrants and options to purchase up to 694,800 common shares. On June 27, 2005, 10% of these securities were released from escrow, leaving a balance in escrow of 445,880 common shares, and warrants and options to purchase up to 625,320 common shares. On September 8, 2006, 288,000 of these warrants were exercised, leaving a balance in escrow of 733,880 common shares, and warrants and options to purchase up to 337,320 common shares. On December 27, 2005, an additional 15% of the original number of securities was released from escrow, leaving a balance in escrow of 659,567 common shares, and warrants and options to purchase up to 233,100 common shares.

**Fortuna Silver Mines Inc.****(Formerly Fortuna Ventures Inc.)**

Notes to the Interim Consolidated Financial Statements

(Unaudited – Prepared by Management)

Three Months Ended December 31, 2005 – Page 7

**6. Capital Stock (cont'd)****Escrow Securities (cont'd)**

Subsequent to December 31, 2005 releases will be as follows:

25% of the original number securities placed in escrow: January 20, 2006 (released)

25% of the original number securities placed in escrow: June 27, 2006

25% of the original number securities placed in escrow: December 27, 2006

**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 \$82,225 recognized for the three months ended December 31, 2005 is associated with the granting of options to a consultant, directors and employees. These compensation charges have been determined under the fair value method using the Black-Scholes option pricing model with the following assumptions:

Risk-free interest rate	3.92%
Expected stock price volatility	90.1%
Expected term in years	5
Expected dividend yield	0.0%

**7. Segmented Information**

Details of identifiable assets by geographic segments are as follows:

	<u>December 31, 2005</u>	<u>Sept 30, 2005</u>
Canada		
Current assets	\$ 5,361,506	\$ 5,846,705
Plant and equipment	21,110	18,624
	<u>\$ 5,382,616</u>	<u>\$ 5,865,329</u>
Peru		
Current assets	\$ 104,341	\$ 82,452
Resource properties	19,386,609	18,179,522
	<u>\$ 19,490,950</u>	<u>\$ 18,261,974</u>
Guatemala		
Current assets	\$ 9,950	\$ 2,455
Plant and equipment	2,910	2,910
	<u>\$ 12,860</u>	<u>\$ 5,365</u>
Mexico		
Resource properties	\$ 5,434	\$ -
Latin America - General		
Resource properties	\$ 10,243	\$ 8,471
	<u>\$ 24,902,103</u>	<u>\$ 24,141,139</u>

## 8. 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.

During the three months ended December 31, 2005 the following non-cash transactions occurred:

	<u>Number of shares</u>	<u>Amount</u>
Shares issued for property acquisition, previously booked as an obligation	1,897,621	\$2,713,598
Warrants issued for property acquisition, previously booked as an obligation	1,613,238	\$1,871,356

## 9. Asset Retirement Obligation

The asset retirement obligation is calculated based on all costs that the Company is required to pay to comply with Peruvian environmental standards when the unit mine closes. The calculation has been done considering that the mine has mineral reserves for approximately 3.7 years. The costs that are required to be incurred are the following:

Treatment and recovery of deposit zone of residues from the mine	\$ 988,268
Close of the mine and re-location of rock piles	758,456
Other	<u>140,509</u>
Expected cash flow before inflation adjustment	1,887,233
Inflation factor (2.5% per year for 3.7 years)	<u>1.0957</u>
Expected cash flow adjusted for inflation	2,067,841
Market risk premium (5%)	<u>103,392</u>
Expected cash flow adjusted for market premium	<u>\$2,171,233</u>
Present value using credit-adjusted risk-free rate of 9% per year	<u>\$1,578,441</u>

The rate of 9% per year corresponds to the financial interest rate that could be obtained by the shareholders, and in management's opinion this rate corresponds to the best estimate of the interest rate the Company could obtain to finance its operations.

## 10. Subsequent Events

a) The Company paid a finders fee in connection with its option agreement on the San Jose Project, Mexico by issuing 50,000 shares at a deemed price of \$1.36 per share and warrants to purchase an additional 50,000 shares exercisable at \$1.50 for one year.

b) The Company received a total of \$761,681 from the exercise of warrants and stock options.



## **MANAGEMENT'S DISCUSSION AND ANALYSIS** **First Quarter Report – December 31, 2005**

### **General**

This Management's Discussion and Analysis ("MD&A") supplements the unaudited financial statements of Fortuna Silver Mines Inc. (the "Company") for the three months ended December 31, 2005. The following information, prepared as of February 23, 2006, should be read in conjunction with the December 31, 2005 financial statements, which have been prepared in accordance with Canadian generally accepted accounting principles. All amounts are expressed in Canadian dollars unless otherwise indicated. The December 31, 2005 financial statements have not been reviewed by the Company's auditors.

### **Business of the Company**

The Company is an emerging silver-gold and base metal producer focused on Latin America., with its principal assets being the Caylloma Silver Mine in southern Peru and the San Jose Silver-Gold Project in Oaxaca, Mexico. The Tambor Gold project was optioned from Radius Gold in 2004, and the Company had plans for an extensive program of drilling and underground development on this high grade gold deposit. However, in light of recent acquisitions and a primary focus on silver, the Company has decided to drop the Tambor option.

#### **Peru – Caylloma Silver Mine**

At its 100% owned Caylloma Silver Mine located in southern Peru, Fortuna has concluded the engineering and design phase and is currently engaged in procurement of equipment, materials and contractor selection in preparation for mine development and plant repairs. Production is expected to begin in the third quarter of this year, and the Company will invest up to \$6.5 million in capital expenditures on these items over 3 years. The Company has an ongoing surface and underground drill program of 5,000 meters for the remainder of the year with the goal of expanding the current NI 43-101 compliant estimate of 7 million ounces silver in proven and probable reserves (776,350 tonnes at 9.2 opt) and 14 million ounces silver in inferred resources (1,146,599 tonnes at 12.4 opt), plus significant lead and zinc byproduct credits.

Phase I underground exploration drilling at the polymetallic Animas vein has concluded and a new geologic model incorporating Ag-Pb-Zn polymetallic mineralization is being constructed. The polymetallic mineralization at Animas was not included in the current resource estimate by the previous owners and it has significant potential to increase the size of the resource once included. The Animas structure is at least 3,800m long and locally up to 20m wide and may be amenable to bulk tonnage mining methods. A full technical report outlining the original 600 tpd production model is available on the Company's website at [www.fortunasilver.com](http://www.fortunasilver.com).

The Company is working to reopen the mine in the third quarter of 2006 and ongoing underground and surface drilling is designed to help upgrade existing resources and find new mineralization. .

At the La Plata vein, for example, recent drilling has intersected new high grade silver and gold mineralization, with a best interval of 1.35m @ 1387 gpt Ag, 16.5 gpt Au.

La Plata is just one of numerous high grade “traditional” veins which comprise the extensive silver-lead-zinc and gold mineralized system at Caylloma Silver Mine. The vein is located only 0.5 km south of the larger polymetallic Animas vein and within 1.5 km of the processing plant.

#### Capital Expenditures

Detailed financial and production models were prepared as part of the Company’s acquisition due diligence, based on the existing resource estimate. These models indicate required capital expenditures of approximately US\$6.5 million over three years.

The plant expenditures include allowances for the addition of a zinc recovery circuit to process polymetallic ore from the Animas vein, and to allow an increase in production rates to 1000 tpd.

Production was modeled at 210,000 tonnes of ore per year, resulting in annual sales approaching 2 million ounces of silver per year. Net smelter returns were estimated at roughly \$14 million per year using the following metal prices; US\$6.00/ounce Ag, US\$400/ounce Au, US\$0.45/lb Zn, US\$0.29/lb Pb..

The Company will update these production and financial models as appropriate, to reflect changes in production scenarios on the Animas vein and metal prices.

#### Peru – Julia Silver Project

Fortuna is also working to consolidate a commanding land position in one of the most productive silver-gold vein camps in Peru. The recently announced acquisition of the Julia vein (Dec. 5, 2005 press release), situated just 10km from Caylloma, includes chip sample results up to 16.87 g/t Au and 64 g/t Ag over 2.31 meters across the vein. The Company has also acquired an additional ground surrounding the historic Sukuytambo Mine, which last produced in the 1980’s and reported historic head grades ranging from 180 to 466 g/t silver and 4 g/t gold. Field crews will be exploring these projects in 2006, with the goal of determining the viability of these prospects to become small high grade satellite operations to the Caylloma mill, which is located within easy trucking distance.

#### Mexico – San Jose Silver-Gold Project

In November 2005, the Company reached an agreement with Continuum Resources Ltd. (TSXV:CNU) in which Fortuna can earn a 70% interest in Continuum’s 80% share of the San Jose silver-gold deposit located in Oaxaca, Mexico. The agreement calls for Fortuna to spend CAD\$2 million in exploration over the next 24 months, primarily on diamond drilling, and includes a CAD\$1 million private placement into Continuum by Fortuna at a price of \$0.20 per share. At the termination of the drill program, and based on a NI 43-101 compliant resource calculation, Fortuna will pay Continuum US\$0.50 for each ounce of silver or silver equivalent in the Measured resource category, and US\$0.35 for each ounce of silver or silver equivalent in the Indicated resource category corresponding to the interest of Fortuna in the ounces.

In January, 2006, two core drilling rigs were mobilized to the San Jose project in Oaxaca. First assay results are expected in March. The San Jose vein has returned very encouraging results from initial sampling, with underground channel sample values up to 10 g/t gold and 1,100 g/t silver over 2.3m average widths, from

existing workings on the Trinidad zone (see Fortuna press release of November 16, 2005 and Continuum Resources Ltd. press release of May 10, 2005).

Fortuna has budgeted for a 10,000m drill program which will involve infill drilling on the Trinidad zone to allow preparation of a resource estimate, as well as wider spaced step outs along the 3km long vein system to identify additional mineralization.

### Acquisitions

Fortuna is constantly evaluating new opportunities in order to meet our corporate objective of building significant silver inventory and future cash flow, by acquiring advanced projects and near term producers accretive to shareholder value. Through this aggressive growth strategy, the Company has obtained interests in two significant projects in less than a year, with high expectations for additional success in the coming months. We look forward to continued growth through the advancement and development of our existing projects and future acquisitions.

### Results of Operations

For the three months ended December 31, 2005, the Company had a net loss of \$616,314 (\$0.03 per share) compared to a net loss of \$105,510 (\$0.02 per share) for the three months ended December 31, 2004. Every category of corporate expenses in the current period have increased significantly compared to the 2004 period due to the overall increase in the Company's exploration and corporate activity. The most significant increases have occurred in the areas of public relations, management and consulting fees, regulatory fees, and travel.

### Quarterly Information

The following table provides information for the eight fiscal quarters ended December 31, 2005:

	First Quarter ended Dec. 31, 2005 (\$)	Fourth Quarter ended Sept. 30, 2005 (\$)	Third Quarter ended June 30, 2005 (\$)	Second Quarter ended Mar. 31, 2005 (\$)	First Quarter ended Dec. 31, 2004 (\$)	Fourth Quarter ended Sept. 30, 2004 (\$)	Third Quarter ended June 30, 2004 (\$)	Second Quarter ended Mar. 31, 2004 (\$)
<b>Total Income</b>	18,464	279	-	-	-	-	-	-
<b>Net Loss</b>	616,314	202,166	151,070	146,887	105,510	16,473	36,067	54,850
<b>Net Loss per share</b>	0.03	0.02	0.02	0.023	0.016	0.006	0.020	0.030

### Mineral Property Expenditures

During the three months ended December 31, 2005, the Company spent approximately \$599,124 on exploration of its properties, including \$552,407 in Peru, \$39,511 in Guatemala, \$5,434 and \$1,772 on property evaluations in Latin America. The Company decided to terminate its option on the Tambor Project in Guatemala, and therefore wrote off all expenditures incurred during the quarter.

### Liquidity and Capital Resources

The Company's cash resources decreased during the three months ended December 31, 2005 by approximately \$1.68 million. During the period, the Company received \$16,450 from the exercise of stock options, and

\$811,389 towards the private placement financing which closed during the quarter. The Company invested \$1.0 million by purchasing shares in Continuum Resources Ltd., the Company's joint venture partner in Mexico. Subsequent to the quarter end, certain stock options and warrants were exercised, providing the Company with additional cash proceeds of approximately \$672,000. Working capital decreased from a deficiency of \$218,826 at September 30, 2005 to a deficiency of 1,593,328 at December 31, 2005.

The Company must raise additional funds in order to cover the final note payable on its Caylloma Mine acquisition. Accordingly, management is currently negotiating the terms of a financing to provide sufficient working capital to cover the Company's expenses for the next 12 months. Actual funding requirements may vary from those planned due to a number of factors, including the progress of exploration and development activity. Management believes it will be able to raise equity capital as required in both the short and long term, but recognizes the uncertainty attached thereto. The Company continues to use various strategies to minimize its dependence on equity capital, including the securing of joint venture partners where appropriate.

**Other Data**

Additional information related to the Company is available for viewing at [www.sedar.com](http://www.sedar.com).

***Share Position and Outstanding Warrants and Options***

The Company's outstanding share position at February 23, 2006 is 27,037,643 common shares. In addition, a total of 19,656,854 share purchase warrants and incentive stock options are currently outstanding as follows:

<u>Type of Security</u>	<u>Number</u>	<u>Exercise Price</u>	<u>Expiry Date</u>
Warrants	1,500,000	\$0.75	June 28, 2006
	50,000	\$1.50	February 20, 2007
	372,643	\$0.80	September 26, 2007
	9,550,000	\$1.00 / \$1.25	September 26, 2007
	189,056	\$0.80	October 6, 2007
	3,997,300	\$1.00 / \$1.25	October 6, 2007
	862,117	\$0.345	June 27, 2010
	<u>1,613,238</u>	\$0.345	November 17, 2010
	18,134,354		
Options	150,000	\$0.80	July 24, 2006
	372,500	\$0.37	December 2, 2009
	125,000	\$0.72	July 13, 2010
	80,000	\$0.80	July 24, 2010
	85,000	\$1.35	November 17, 2010
	<u>710,000</u>	\$1.35	February 5, 2016
		1,522,500	

**Related Party Transactions**

The Company incurred charges with companies having a common director or officer as follows:

	Three Month Period Ending December 31,	
	<u>2005</u>	<u>2004</u>
Deferred exploration costs – geological fees	\$ 11,930	\$ -
Consulting fees	\$ 22,649	\$27,000
Salaries and wages	\$ 6,884	\$ -
Management fees	\$ 20,800	\$ 2,630

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

At December 31, 2005, accounts payable and accrued liabilities included \$491 (Sept 2005: \$181,036) due to directors of the Company and accounts receivable included \$430 (Sept 2005: \$215) due from a director of the Company.

At December 31, 2005, due to related parties consists of amounts owing to a company with a common director which were incurred as a result of shared administrative costs. This amount is unsecured, non-interest bearing and payable in the normal course of business.

#### **Subsequent Events**

- (a) The Company paid a finders fee in connection with its option agreement on the San Jose Project, Mexico by issuing 50,000 shares at a deemed price of \$1.36 per share and warrants to purchase an additional 50,000 shares exercisable at \$1.50 for one year.
- (b) The Company received a total of \$761,681 from the exercise of warrants and stock options.

#### **Financial Instruments**

The carrying value of cash and cash equivalents, receivables, due from/to related parties and accounts payable and accrued liabilities approximate fair value because of the short-term maturity of those instruments. Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments.

#### **Forward Looking Information**

Certain statements contained in this MD&A and elsewhere constitute forward-looking statements. Such forward-looking statements involve a number of known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the company to materially differ from any future results, performance or achievements expressed or implied by such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date the statements were made, and readers are advised to consider such forward-looking statements in light of the risks set forth below.

### **Risks and Uncertainties**

The business of mineral exploration and extraction involves a high degree of risk. Few properties that are in the exploration stage ultimately become producing mines. The Company's mineral properties are located in emerging nations and consequently may be subject to a higher level of risk compared to developed countries. Operations, the status of mineral property rights, title to the properties and the recoverability of amounts shown for mineral properties in emerging nations can be affected by changing economic, regulatory and political situations. Other risks facing the Company include competition, environmental and insurance risks, fluctuations in metal prices, share price volatility and uncertainty of additional financing.

### **Internal Disclosure Controls and Procedures**

We have evaluated the effectiveness of our disclosure controls and procedures and have concluded that they are sufficiently effective to provide reasonable assurance that material information relating to the Company and its consolidated subsidiaries is made known to management and disclosed in accordance with applicable securities regulations.

