



F O R T U N A
S I L V E R M I N E S I N C .

FINANCIAL REVIEW

Fiscal Year Ended December 31, 2008

FORTUNA SILVER MINES INC.

CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2008 AND DECEMBER 31, 2007

(Expressed in thousands of Canadian Dollars)

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Auditors' report

To the Shareholders of
Fortuna Silver Mines Inc.

We have audited the consolidated balance sheet of Fortuna Silver Mines Inc. as at December 31, 2008 and the consolidated statements of operations and comprehensive loss, shareholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The consolidated financial statements as at December 31, 2007 and for the year then ended were audited by other auditors who expressed an opinion without reservation on those statements in their audit report dated March 20, 2008.

Deloitte & Touche LLP

Chartered Accountants
March 31, 2009

FORTUNA SILVER MINES INC.
CONSOLIDATED BALANCE SHEETS
AS AT DECEMBER 31
(Expressed in thousands of Canadian Dollars)

	2008	2007
ASSETS		
CURRENT		
Cash and cash equivalents	\$ 36,017	\$ 47,240
Derivatives (Note 4)	1,734	1,400
Accounts receivable and prepaid expenses (Note 5)	2,281	2,051
GST and value added tax	6,269	5,147
Inventories (Note 6)	2,112	1,693
	48,413	57,531
LONG-TERM RECEIVABLES	139	-
LONG-TERM INVESTMENT AND RECEIVABLE (Note 7)	3,781	908
PROPERTY, PLANT & EQUIPMENT (Note 8)	16,245	13,669
MINERAL PROPERTIES (Note 9)	72,494	52,338
	\$ 141,072	\$ 124,446
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	\$ 5,790	\$ 5,917
Due to related parties, net (Note 10)	47	14
Current portion of obligation under capital lease (Note 11)	834	439
Current portion of long-term liability (Note 11)	98	-
	6,769	6,370
OBLIGATIONS UNDER CAPITAL LEASE (Note 11)	876	433
LONG-TERM LIABILITY (Note 11)	813	-
ASSET RETIREMENT OBLIGATION (Note 12)	1,304	1,916
FUTURE INCOME TAX LIABILITY (Note 13)	11,507	8,069
NON-CONTROLLING INTEREST (Note 9)	11,013	6,593
	32,282	23,381
SHAREHOLDERS' EQUITY		
SHARE CAPITAL (Note 14)	108,221	100,159
CONTRIBUTED SURPLUS	13,171	11,770
DEFICIT	(11,972)	(11,008)
ACCUMULATED OTHER COMPREHENSIVE (LOSS) INCOME (Note 15)	(630)	144
	108,790	101,065
	\$ 141,072	\$ 124,446

Nature and continuance of operations (Note 1)

Commitments and contingencies (Note 18)

Subsequent events (Note 21)

APPROVED BY THE DIRECTORS:

"signed", Director
Jorge Ganoza Durant

"signed", Director
Simon Ridgway

(See accompanying Notes)

FORTUNA SILVER MINES INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
(Expressed in thousands of Canadian Dollars, except for share and per share amounts)

	<u>2008</u>	<u>2007</u>
Sales	\$ 26,339	\$ 31,667
Cost of sales (including depletion, depreciation and accretion of \$5,681 (2007 \$5,766))	<u>22,209</u>	<u>18,447</u>
MINE OPERATING INCOME	<u>4,130</u>	<u>13,220</u>
Selling, general and administrative expenses (includes depreciation of \$52 (2007 \$32))	8,278	6,127
Stock-based compensation (Note 14)	1,428	6,974
Write-off of deferred exploration costs	<u>349</u>	<u>12</u>
	<u>10,055</u>	<u>13,113</u>
OPERATING (LOSS) INCOME	(5,925)	107
Interest and other income and expenses	1,442	1,529
Interest and finance expenses	(103)	(90)
Net gain on commodity contracts (Note 4)	4,521	1,558
Loss on disposal of property, plant and equipment	(47)	(59)
Foreign exchange gain (loss)	<u>839</u>	<u>(1,665)</u>
	<u>6,652</u>	<u>1,273</u>
INCOME BEFORE INCOME TAXES AND NON- CONTROLLING INTEREST	727	1,380
Income tax provision (Note 13)	1,799	4,261
Non-controlling interest	<u>(108)</u>	<u>(92)</u>
NET LOSS FOR THE YEAR	(964)	(2,789)
Other comprehensive loss, net of tax Unrealized loss on available for sale long-term investments	<u>(774)</u>	<u>(305)</u>
COMPREHENSIVE LOSS FOR THE YEAR	<u>\$ (1,738)</u>	<u>\$ (3,094)</u>
Loss per share – Basic and diluted	\$ (0.01)	\$ (0.04)
Weighted average number of shares outstanding – Basic and diluted	84,400,969	71,602,275

(See accompanying Notes)

FORTUNA SILVER MINES INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
(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	46,587,728	\$ 43,341	\$ 6,085	\$ (8,219)	\$ -	\$ 41,207
Cumulative impact of accounting changes, net of tax (Note 15)	-	-	-	-	449	449
Exercise of options	1,753,600	1,957	-	-	-	1,957
Exercise of warrants	14,214,035	21,057	-	-	-	21,057
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	-	1,289	(1,289)	-	-	-
Stock based compensation	-	-	6,974	-	-	6,974
Issue costs (non-cash amount \$802)	-	(2,487)	-	-	-	(2,487)
Loss for the year	-	-	-	(2,789)	-	(2,789)
Other comprehensive loss, net of tax	-	-	-	-	(305)	(305)
Balance December 31, 2007	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	-	-	1,428	-	-	1,428
Loss for the year	-	-	-	(964)	-	(964)
Other comprehensive loss, net of tax	-	-	-	-	(774)	(774)
Balance December 31, 2008	85,331,659	\$ 108,221	\$ 13,171	\$ (11,972)	\$ (630)	\$ 108,790

(See accompanying Notes)

FORTUNA SILVER MINES INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
(Expressed in thousands of Canadian Dollars)

	2008	2007
OPERATING ACTIVITIES		
Net loss for the year	\$ (964)	\$ (2,789)
Items not involving cash		
Depletion and depreciation	5,667	5,640
Accretion expense	108	158
Future income tax	1,799	3,717
Stock based compensation	1,428	6,974
Unrealized loss (gain) on commodity contracts	9	(1,466)
Non-controlling interest	(108)	(92)
Write-off of deferred exploration costs	349	12
Loss on disposal of equipment	47	59
Other	24	-
Unrealized foreign exchange loss (gain)	807	(515)
Changes in non-cash working capital items		
Accounts receivable and prepaid expenses	270	(527)
Inventories	(436)	(798)
Accounts payable	(182)	2,877
Payments from (to) related parties (Note 10)	33	(13)
Net cash from (used in) operating activities	8,851	13,237
FINANCING ACTIVITIES		
Net proceeds on issuance of common shares	8,035	55,528
Capital lease obligations	(372)	(132)
Repayment of debt (Note 11)	-	(5,730)
Net cash from financing activities	7,663	49,666
INVESTING ACTIVITIES		
Mineral property expenditures	(22,455)	(10,515)
Value added taxes on purchase of property, plant and equipment	(1,560)	(1,033)
Property, plant & equipment expenditures	(3,744)	(5,795)
Long term receivable	(17)	-
Proceeds from disposal of equipment	39	39
Net cash used in investing activities	(27,737)	(17,304)
INCREASE (DECREASE) IN CASH	(11,223)	45,599
Cash and cash equivalents – beginning of period	47,240	1,641
CASH AND CASH EQUIVALENTS – END OF PERIOD	\$ 36,017	\$ 47,240
Supplementary disclosure of cash flow information:		
Cash received for interest	\$ (1,500)	\$ (1,504)
Cash paid for income taxes	\$ 507	\$ 608

Non-cash transactions (Note 17)

(See accompanying Notes)

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

(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.

These consolidated financial statements have been prepared using Canadian generally accepted accounting standards (“Canadian GAAP”) applicable to going concern, which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. For the years ended December 31, 2008 and 2007, the Company had net losses of \$964 and \$2,789, respectively, and as at December 31, 2008, had an accumulated deficit of \$11,972. The Company’s continuing operations as a going concern 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.

2. Significant Accounting Policies

a) Basis of presentation

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”). The 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.

b) Significant Changes in Accounting Policy

On January 1, 2008, the Company adopted four new Handbook Sections of the Canadian Institute of Chartered Accountants (“CICA”): Section 1535, “Capital Disclosures”, Section 3031, “Inventories”, Section 3862, “Financial Instruments-Disclosure” and Section 3863, “Financial Instruments – Presentation”. The adoption of these guidelines did not have a material effect on the Company’s results, financial position or cash flows.

Section 1535 “Capital Disclosures”, establishes standards for disclosing information about an entity’s capital and how it is managed. These standards require a company to disclose its objectives, policies and processes for managing capital along with summary quantitative data about what it manages as capital. In addition, disclosures are to include whether a company has complied with externally imposed capital requirements and when a company has not complied with capital requirements, the consequences of such non-compliance.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

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

2. Significant Accounting Policies (continued)

Section 3031, "Inventories", replaces the existing inventories standard. The new standard requires inventory to be valued on a first-in, first-out or weighted average basis, which is consistent with the Company's current treatment. The adoption of this standard does not have a material impact on the Company's Consolidated Financial Statements.

Section 3862 "Financial Instruments – Disclosures" and Section 3863 "Financial Instruments – Presentation", replace Section 3861 "Financial Instruments – Disclosure and Presentation". The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and in addition requires companies to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments for the company's financial position and performance and the nature and extent of risks arising from financial instruments to which the company is exposed during the period and at the balance sheet date, and how the company manages those risks. The new presentation standard carries forward the former presentation requirements.

c) Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Significant items subject to such estimates and assumptions include the fair values of financial instruments and derivatives, determination of mineral reserves, the carrying amount of mineral property, plant and equipment, assay grades of metal concentrates sold, valuation of inventories and future income taxes, recoverability of receivables, provisions for asset retirement obligation and reclamation, fair value estimation of acquisitions and stock-based awards. Actual results could differ from those estimates.

d) Revenue Recognition

Revenue arising from the sale of metal concentrates is recognized when title and the significant risks and rewards of ownership of the concentrates have been transferred to the buyer. The passing of title to the customer is based on the terms of the sales contract and final commodity prices are set on a specified quotational period, either one or three months after delivery at the option of the customer. The Company's metal concentrates are provisionally priced at the time of sale based on the prevailing market price. Variations recorded between the price recorded at the time of provisional settlement and the actual final price is caused by changes in metal prices.

e) Cash and cash equivalents

Cash and cash equivalents include highly liquid investments with original maturities of ninety days or less.

f) Long-term investments

Long-term investments are those investments which the Company will be retaining for a period longer than one year. These investments are classified as available-for-sale and are recorded at fair value.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

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

2. Significant Accounting Policies (continued)

g) Property, Plant and Equipment

Property, plant and equipment are recorded at cost and are depreciated over the estimated economic life of the asset on a straight line basis as follows:

Buildings, mine site	Life of mine
Buildings, other	20 – 30 years
Machinery and equipment	3 – 8 years
Furniture and other equipment	4 – 10 years
Transport units	4 – 5 years

The expected remaining life of the mine as at December 31, 2008 is 7.3 years. Land is not depreciated. Equipment under capital lease is initially recorded at the present value of minimum lease payments at the inception of the lease.

h) Amortization and Mineral Properties Cost

The Company defers the cost of acquiring, maintaining its interest, exploring and developing mineral properties when future inflow of economic benefits from the properties is probable and until such time as the properties are placed into production, abandoned, sold or considered to be impaired in value. Costs of producing properties, including capitalized interest are amortized on a unit-of-production basis over proven and probable reserves and costs of abandoned properties are written-off. Proceeds received from 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. Exploration costs that do not relate to any specific property are expensed as incurred.

i) Operational Mining Properties and Mine Development

For operating mines all exploration within the mineral deposit is capitalized and amortized on a unit-of-production basis over proven and probable reserves as part of the production cost.

Costs associated with commissioning activities on constructed plants are deferred from the date of mechanical completion of the facilities until the date the Company is ready to commence commercial production. Any revenues earned during this period are recorded as a reduction in deferred commissioning costs. These costs are amortized using the units-of-production method over the life of the mine, commencing on the date of commercial service.

Significant payments related to the acquisition of land and mineral rights are capitalized as incurred. Prior to acquiring such land or mineral rights the Company makes a preliminary evaluation to determine that the property has significant potential to develop an economic ore body. The time between initial acquisition and full evaluation of a property's potential is dependent on many factors including: location relative to existing infrastructure, the property's stage of development, geological controls and metal prices. If a mineable ore body is discovered, such costs are amortized when production begins. If no mineable ore body is discovered, such costs are expensed in the period in which it is determined the property has no future economic value. In countries where we have paid Value Added Tax ("VAT") and where there is uncertainty

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

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

2. Significant Accounting Policies (continued)

of its recoverability, the VAT payments will be deferred with mineral property costs relating to the property or expensed if the exploration costs have been expensed according to our policy. If we ultimately recover amounts that have been deferred, the amount received will be applied to reduce mineral property costs or taken as a credit against current expenses depending on the prior treatment.

j) Asset Impairment

Management reviews and evaluates its long-lived assets for impairment when events or changes in circumstances indicate that the related carrying amounts may not be recoverable. Impairment is considered to exist if total estimated future cash flows or probability-weighted cash flows on an undiscounted basis are less than the carrying amount of the assets, including mineral property, plant and equipment and producing and non-producing properties. An impairment loss is measured and recorded based on discounted estimated future cash flows or the application of an expected present value technique to estimate fair value in the absence of a market price. Future cash flows are based on recoverable proven and probable reserves and a portion of recoverable resources, silver, zinc, copper, lead and gold prices (considering current and historical prices, price trends and related factors), production levels, capital and reclamation costs, all based on detailed engineering life-of-mine plans. Assumptions underlying future cash flow estimates are subject to risks and uncertainties. Any differences between significant assumptions and market conditions and/or the Company's performance could have a material effect on any impairment provision, and on the Company's financial position and results of operations. In estimating future cash flows, assets are grouped at the lowest levels for which there are identifiable cash flows that are largely independent of cash flows from other groups. Generally, in estimating future cash flows, all assets are grouped at a particular mine for which there is identifiable cash flow.

k) Asset Retirement Obligation

The fair value of an obligation associated with the retirement of a tangible long-lived asset is 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 liability is accreted over time for changes in the fair value of the liability through charges, 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 assets.

l) Inventories

Effective January 1, 2008, the Company adopted CICA Handbook Section 3031, "Inventories", which replaces Section 3030, "Inventories". The new section establishes standards for the measurement and disclosure of inventories, including the determination of cost 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. The adoption of this standard did not have a material impact on the consolidated financial statements.

Ore stockpile and finished goods inventories are valued at the lower of production cost and net realizable value. Materials and supplies are valued at the lower of average cost and net realizable value. Production costs include all mine site costs.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

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

2. Significant Accounting Policies (continued)

m) Income Taxes

The Company uses the asset and liability method of accounting for income taxes in accordance to the CICA Handbook Section 3465 "*Income Taxes*". Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the year that includes the date of substantive enactment. Future tax assets are recognized to the extent that they are considered more likely than not to be realized.

n) Stock-based Compensation

The Company has a share option plan which is described in Note 14. The Company records all stock-based compensation relating to options granted using the fair value method such that stock-based payments are measured at fair value and 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.

o) Basic and Diluted Loss Per Share

Basic loss per share ("LPS") is calculated by dividing the net loss applicable to common shareholders by the weighted average number of common shares outstanding for the year. Potentially dilutive outstanding options and warrants are excluded from the calculation of LPS, as they would be anti-dilutive.

p) Foreign Currency Translation

The Company's subsidiaries are accounted for as integrated foreign operations. Monetary items denominated in a foreign currency are translated into Canadian dollars at exchange rates prevailing at the balance sheet date and non-monetary items are translated at exchange rates prevailing when the assets were acquired or obligations incurred. Foreign currency denominated revenue and expense items are translated at the exchange rates prevailing at the transaction date. Foreign currency transaction gains and losses are included in the determination of net income or loss.

q) Financial Instruments

The Company applies as prescribed Section 3855, "Financial Instruments – Recognition and Measurement". CICA Standard 3855 establishes standards for recognizing and measuring financial assets, financial liabilities, and non-financial derivatives. Under CICA 3855, all financial assets must be classified as either held-for-trading, available-for-sale, held-to-maturity investments or loans and receivables. All financial liabilities must be classified as held-for-trading or other financial liabilities. All financial instruments, including derivatives, are included on the Consolidated Balance Sheets and are measured at fair value, except for held-to-maturity investments, loans and receivables which are long-term, and other financial liabilities which are long-term, and these are all measured at amortized cost. The carrying value of receivables, and accounts payable and accrued liabilities approximate their fair value because of the short-term maturity of those instruments. Subsequent measurements and recognition of changes in fair value

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

FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

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

2. Significant Accounting Policies (continued)

depend on the instrument's initial classification. Held-for-trading financial instruments are measured at fair value, and all gains and losses are included in net income (loss) in the period in which they arise. Available-for-sale financial instruments are measured at fair value, determined by published market prices in an active market, except for investments in equity instruments that do not have quoted market prices in an active market which are measured at cost. Changes in fair value are recorded in other comprehensive income (loss) until the assets are removed from the balance sheet. Investments classified as available-for-sale are written down to fair value through income whenever it is necessary to reflect other than-temporary impairment. Realized gains and losses on the disposal of available-for-sale securities are recognized in investment and other income. Also, transaction costs related to all financial assets and liabilities are recorded in the acquisition or issue cost, unless the financial instrument is classified as held-for-trading, in which case the transaction costs are recognized immediately in net income (loss).

CICA Section 3855 also requires financial and non-financial derivative instruments to be measured at fair value and recorded as either assets or liabilities. Certain derivatives embedded in non-derivative contracts must also be measured at fair value. Any changes in the fair value of recognized derivatives are included in net income (loss) for the period in which they arise, unless specific hedge accounting criteria are met, as defined in CICA Section 3865. The same accounting treatment applied to these non-financial derivative contracts prior to the adoption of CICA Section 3855. Fair values for the Company's recognized commodity-based derivatives are based on the forward prices of the associated market index.

The Company has designated each of its significant categories of financial instruments as of January 1, 2007 as follows:

<u>Financial Instrument</u>	<u>Classification</u>	<u>Measurement</u>
Cash and cash equivalents	Held for trading	Fair value
Accounts receivable	Loans and receivable	Fair value
Derivatives	Held for trading	Fair value
Long term receivables	Loans and receivable	Amortized cost
Long term investments	Available for sale	Fair value
Accounts payable and accrued liabilities	Other liabilities	Fair value
Long term liability	Other liabilities	Amortized cost

r) Derivatives and Trading Activities

The Company employs metals and currency contracts, including forward contracts to manage exposure to fluctuations in metal prices and foreign currency exchange rates. For metals production, these contracts are intended to reduce the risk of falling prices on the Company's future sales. Foreign currency derivative financial instruments, such as forward contracts are used to manage the effects of exchange rate changes on foreign currency cost exposures. Changes in the fair value of derivative instruments are reported in income or accumulated other comprehensive income ("AOCI"), depending on the use of the derivative and whether it qualifies for hedge accounting treatment under the provisions of CICA 3865, "Hedges". Unrealized gains and losses on derivative instruments qualifying as cash flow hedges are recorded in AOCI to the extent the hedges are effective, until the underlying transactions are recognized in the Consolidated Statement of Operations.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

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

2. Significant Accounting Policies (continued)

The ineffective portions of cash flow hedges are recognized in income immediately. All derivative instruments are recorded on the balance sheet at fair value. Unrealized gains and losses on derivative instruments that do not qualify or are not designated as hedges are marked to market at the end of each accounting period with the results included in gain or loss on commodity and foreign currency contracts in the Consolidated Statement of Operations.

Derivatives may be embedded in other financial instruments (host instruments). Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host instrument, the terms of the embedded derivative are the same as those of a standalone derivative, and the combined contract is not classified as held for trading. These embedded derivatives are measured at fair value on the balance sheet with subsequent changes in fair value recognized in income. The Company selected January 1, 2003 as its transition date for embedded derivatives. The Company has not identified any embedded derivatives that are required to be accounted for separately from the host contract.

s) Risk Management

Interest rate risk

The Company holds cash and cash equivalents which earn interest at variable rates as determined by financial institutions.

Credit risk

The Company only places its cash with major financial institutions.

Foreign currency risk

The Company is exposed to currency risk in that its subsidiary operations are transacted in Peruvian Nuevo Soles, Mexican Pesos and the U.S. dollar. The Canadian dollar value of the assets and liabilities of the subsidiary denominated in these three currencies will fluctuate due to changes in foreign exchange. The Company does not use any hedging instruments to reduce its foreign currency exposure.

t) Capital Disclosures

Effective January 1, 2008, the Company adopted CICA Handbook Section 1535 – Capital Disclosures. Section 1535 establishes standards for disclosing information about an entity's capital and how it is managed. These standards require an entity to disclose the following:

- i. its objectives, policies and processes for managing capital;
- ii. summary quantitative data about what the Company views as capital;
- iii. whether during the period, it complied with any externally imposed capital requirements to which it is subject;
- iv. when the entity has not complied with such requirement, the consequences of such non-compliance.

The Company has included the disclosures recommended by the new Handbook section in Note 20 to these consolidated financial statements.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

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

2. Significant Accounting Policies (continued)

u) Financial Instruments – Presentation and Disclosure

Effective January 1, 2008, the Company adopted CICA Handbook Sections 3862 “*Financial Instruments - Disclosures*” and Section 3863 “*Financial Instruments - Presentation*”. These standards replace CICA 3861, Financial Instruments – Disclosure and Presentation. They increase the disclosures currently required, which will enable users to evaluate the significance of financial instruments for an entity's financial position and performance, including disclosures about fair value. In addition, disclosure is required of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk. The quantitative disclosures must provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel.

The Company has included the disclosures recommended by the new Handbook section in Note 21 to these consolidated financial statements.

v) Comprehensive Income

Effective January 1, 2007, the Company adopted CICA Handbook Section 1530 Comprehensive Income. Comprehensive income is the change in net assets that results from transactions, events and circumstances from sources other than the Company's shareholders and includes items that would not normally be included in net earnings such as unrealized gains or losses on available-for-sale investments. Other comprehensive income includes the holding gains and losses from available for-sale securities which are not included in net income (loss) until realized.

3. Recent released Canadian Accounting Standards

The Company has assessed new and revised accounting pronouncements that have been issued that are not yet effective and determined that the following may have an impact on the Company:

Goodwill and Intangible Assets (Section 3064)

In February 2008, the CICA issued section 3064, “Goodwill and Intangible Assets”, which replaces Section 3062, “Goodwill and Intangible Assets,” and CICA Section 3450, “Research and Development Costs,” and CICA Section 1000, “Financial Statement Concepts.” The standard intends to reduce the differences with International Financial Reporting Standards (“IFRS”) in the accounting for intangible assets and results in closer alignment with U.S. GAAP. Under current Canadian standards, more items are recognized as assets than under IFRS or U.S. GAAP. The objectives of CICA Section 3064 are to reinforce the principle-based approach to the recognition of assets only in accordance with the definition of an asset and the criteria for asset recognition; and clarify the application of the concept of matching revenues and expenses such that the current practice of recognizing assets that do not meet the definition and recognition criteria are eliminated. The standard will also provide guidance for the recognition of internally developed intangible assets (including research and development activities), ensuring consistent treatment of all intangible assets, whether separately acquired or internally developed. This standard will be effective for fiscal years beginning on or after October 1, 2008. The Company is currently evaluating the impact of adopting this standard in 2009.

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3. Recent released Canadian Accounting Standards (continued)

International Financial Reporting Standards (“IFRS”)

In 2006, the Canadian Accounting Standards Board (“AcSB”) published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian GAAP with IFRS over an expected five year transitional period. In February 2008 the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canadian GAAP. This date is for interim and annual financial statements relating to fiscal years beginning on or after 1 January 2011. The Company will begin reporting its financial statements in accordance with IFRS on January 1, 2011, with comparative figures for 2010.

The adoption date of January 1, 2011 will require the restatement, for comparative purposes, of amounts reported by the Company for its year ended December 31, 2010, and of the opening balance sheet as at January 1, 2010.

The Company has begun planning its transition to IFRS but the impact on its consolidated financial position and results of operations has not yet been determined. The process will consist of three phases: Scoping and Diagnostics, Analysis and Development, and Implementation and Review. The Company has begun the first phase which includes a diagnostic assessment of its current accounting policies systems and processes in order to identify differences between current Canadian GAAP and IFRS treatment. The Company will continue to monitor changes in IFRS during implementation process and intends to update the critical accounting policies and procedures to incorporate the changes required by converting to IFRS and the impact of these changes on its financial reporting.

Business Combinations

In January 2009, the CICA issued Section 1582, Business Combinations, Section 1601, Consolidations, and Section 1602, Non-controlling Interests. These new standards are harmonized with International Financial Reporting Standards (IFRS). Section 1582 specifies a number of changes, including: an expanded definition of a business, a requirement to measure all business acquisitions at fair value, a requirement to measure non-controlling interests at fair value, and a requirement to recognize acquisition-related costs as expenses. Section 1601 establishes the standards for preparing consolidated financial statements. Section 1602 specifies that non-controlling interests be treated as a separate component of equity, not as a liability or other item outside of equity. The new standards will become effective in 2011 but early adoption is permitted. The Company is evaluating the attributes of early adoption of this standard and its potential effects if events or transactions occurred that this standard applies to.

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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 refers 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. The counterparty is Standard Bank PLC.

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 December 31, 2008 the Company had 1 open position 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 December 31, 2008 the Company had 1 open position on each of these arrangements.

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

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

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

As at December 31, 2008, the Company had 1 open position 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, 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 \$1,734 was determined 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 \$4,521 as at December 31, 2008.

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5. Accounts receivable and prepaid expenses

	December 31, 2008	December 31, 2007
Trade accounts receivable	\$ -	\$ 409
Advances and other receivables	2,080	1,505
Prepaid expenses and deposits	201	137
	<u>\$ 2,281</u>	<u>\$ 2,051</u>

Advances and other receivables include prepaid income tax of \$740 and the \$125 short-term portion of the long-term receivable.

6. Inventories

Inventories consist of the following:

	December 31, 2008	December 31, 2007
Stockpile ore	\$ 110	\$ 466
Concentrate inventory	394	159
Materials and supplies	1,608	1,068
	<u>\$ 2,112</u>	<u>\$ 1,693</u>

7. Long term investment and receivable

At December 31, 2008 and 2007 the Company had an investment in 3,706,250 shares of Continuum Resources Ltd. With the adoption of financial instruments standards, the Company measures these investments at fair value. 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.

	December 31, 2008	December 31, 2007
Fair value	\$ 111	\$ 908
Cost	741	741
Unrealized (loss) gain (cumulative)	<u>\$ (630)</u>	<u>\$ 167</u>

The Company has additionally granted a loan of \$3,670 to Continuum Resources Ltd. under the terms of the agreement by which Fortuna will acquire all of the issued and outstanding shares of Continuum. This amount has been used by Continuum to meet its share of the San Jose project capital contributions as well as general corporate expenditures.

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8. Property, Plant & Equipment

Property, plant and equipment are comprised of the following:

	December 31, 2008		
	Cost	Accumulated Depreciation	Net book value
Land	\$ 283	\$ -	\$ 283
Machinery & equipment	9,619	2,084	7,535
Buildings	4,170	736	3,434
Furniture & other equipment	1,459	267	1,192
Transport units	642	208	434
Equipment under capital lease	1,975	264	1,711
Work in progress	1,656	-	1,656
	<u>\$ 19,804</u>	<u>\$ 3,559</u>	<u>16,245</u>

	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
Transport units	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:

	December 31, 2008			
	Cost	Depletion	Write-off	Net
Caylloma, Peru	\$ 40,249	\$ 8,748	\$ -	\$ 31,501
San Jose, Mexico	41,342	-	349	40,993
	<u>\$ 81,591</u>	<u>\$ 8,748</u>	<u>\$ 349</u>	<u>\$ 72,494</u>

	December 31, 2007			
	Cost	Depletion	Write-off	Net
Caylloma, Peru	\$ 31,063	\$ 4,795	\$ -	\$ 26,268
San Jose, Mexico	26,070	-	-	26,070
Other	12	-	12	-
	<u>\$ 57,145</u>	<u>\$ 4,795</u>	<u>\$ 12</u>	<u>\$ 52,338</u>

9.

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Mineral Properties (continued)

Additions to mineral properties are comprised of development and exploration costs capitalized and consist of \$9,906 at Caylloma and \$15,272 at San Jose properties for the year ended December 31, 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 the additions for the San Jose property is the acquisition of the Monte Alban II concession. This was acquired for a total of US\$1,900 and consists of a payment of US\$1,100 made in May 2008 and a future payment of US\$800 to be made in May 2012. The present value of the US\$800 is \$720 (US\$589) (Note 12). This will be accreted monthly with the accretion amount being capitalized to the mineral property (Note 12). Also included in additions to San Jose mineral properties are depreciation of equipment involved in construction work of \$222 (2007: \$57), and costs to develop the mine of \$1,328 (2007: \$929).

San Jose Project, Mexico

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 \$11,013 has been recorded as at December 31, 2008 (December 31, 2007 - \$6,593).

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.

10. Related Party Transactions

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

	Year ended December 31, 2008	Year ended December 31, 2007
Mineral property costs – geological fees	\$ -	\$ 45
Consulting fees	66	188
Salaries and wages	110	108

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

At December 31, 2008, due to related parties consists of \$47 (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.

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11. Leases and Long-Term Liabilities*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	December 31, 2008	December 31, 2007
Banco Interamericano de Finanzas	8.50%	2009	\$ 46	\$ 82
Scotiabank	9.29%	2009	17	28
Scotiabank	8.20%	2009	163	252
Scotiabank	8.66%	2010	276	335
Scotiabank	8.34%	2010	32	37
Scotiabank	8.20%	2010	653	138
Interbank	9.12%	2011	303	-
Scotiabank	8.49%	2011	85	-
Scotiabank	8.49%	2010	135	-
Lease payments			\$ 1,710	\$ 872
Less current amount			(834)	(439)
			<u>\$ 876</u>	<u>\$ 433</u>

Long-term liability

	December 31, 2008	December 31, 2007
Long-term liability at inception	\$ 992	\$ -
Less: adjustment to amortized cost	(269)	-
Fair value of liability at inception measured at amortized cost	723	-
Add foreign exchange revaluation	168	-
Add accretion to period end	50	-
Less payments	(30)	-
Liability at December 31, 2008	911	-
Less: current portion of long-term liability	(98)	-
	<u>\$ 813</u>	<u>\$ -</u>

In November 2007, Bateas acquired the Minera Condor II and the Minera Condor III concessions for US\$250. US\$50 was paid at the signing of the contract; payments of US\$30 are required to be paid every six months for a total of five payments; and US\$50 is required to be paid November 2010. These payments are non-interest bearing and all debt relating to the acquisition of the mineral resource property has been recognized as at December 31, 2008.

In May 2008, Cuzcatlan acquired the Monte Alban II concession (Note 9) and this includes a payment of \$978 (US\$800) due May 2012. This payment is non-interest bearing all debt relating to the acquisition of the mineral resource property has been recognized as at December 31, 2008.

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11. Leases and Long-Term Liabilities (continued)

Principal minimum repayment terms will be:

	\$
2009	110
2010	98
2011	-
2012	978

Contingent liability

Interbank bank, a third party, has established a bank letter of guarantee on behalf of Minera Bateas in favor of the Peruvian mining regulatory agency in compliance with local regulation associated with the approval procedures of Minera Bateas' mine closure plan, for the sum of \$734 (US\$600). This letter is available against first and simple demand and expires on April 27, 2009. At this point it will be renewed until the end of 2009 when a new guarantee will be set up according to an approved mine closure plan for an amount corresponding to the work to be executed during 2010. This amount is yet to be established but it is expected to be less than the current guarantee.

12. Asset Retirement Obligation

The Company has recorded an asset retirement obligation of \$1,304 as of December 31, 2008 consisting of accretion of the previously recorded asset retirement obligation of \$1,916 as of December 31, 2007 by \$108 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.

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13. Income Tax

- a) Income tax expense differs from the amount that would be computed by applying the Canadian statutory income tax rate of 31.00% (2007 – 34.12%) to loss before income taxes and non-controlling interest. The reasons for the differences are as follows:

	2008	2007
Income before income taxes and non-controlling interest	\$ 727	\$ 1,380
Statutory income tax rate	31.00%	34.12%
Expected income tax	\$ 225	\$ 471
Items non-deductible (deductible) for income tax purposes	757	(74)
Difference between Canadian and foreign tax rates	202	3,202
Change in income tax rates	218	-
Change in future tax assets and liabilities due to changes in foreign exchange	151	-
Change in valuation allowance	246	662
Total income taxes	\$ 1,799	\$ 4,261
Represented by:		
Current income tax	\$ -	\$ 544
Future income tax	1,799	3,717
	\$ 1,799	\$ 4,261

- b) The tax effects of temporary differences that give rise to significant portions of the future tax assets and future tax liabilities at December 31, 2008 and December 31, 2007 are presented below:

	2008	2007
Future income tax assets:		
Non-capital losses	\$ 2,695	\$ 1,275
Share issue costs	431	657
Unrealized foreign exchange losses and other	333	-
Mineral properties and property, plant and equipment	1,542	441
Total future income tax assets	5,001	2,373
Valuation allowance	(2,619)	(2,373)
Net future income tax assets	2,382	-
Future income tax liabilities:		
Mineral properties – Peru	(10,391)	(5,910)
Mineral properties – Mexico	(2,131)	(2,136)
Unrealized foreign exchange gains and other	(1,367)	(23)
	(13,889)	(8,069)
Net future income tax (liabilities)	\$ (11,507)	\$ (8,069)

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13. Income Tax (continued)

The Company has non-capital loss carry-forwards that will expire if unused of \$8,895 that may be available for tax purposes. The loss carry-forwards expire as follows:

Non-capital losses, expiring as follows:	Canada	Peru	Mexico
2009	\$ 104	\$ -	\$ -
2013	122	-	-
2014	698	-	-
2016	-	-	17
2017	-	-	216
2025	985	-	-
2026	466	-	-
2027	2,437	-	-
2028	546	-	-
No expiry	-	3,304	-
	<u>5,358</u>	<u>3,304</u>	<u>233</u>

A full valuation allowance has been recorded against the majority of the potential future income tax assets associated with the Canadian loss carry-forwards as their utilization is not considered more likely than not at this time.

14. Share Capital

a) Authorized: Unlimited common shares without par value

	Number of shares	Amount
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 18)	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 – December 31, 2008	<u>85,331,659</u>	<u>\$ 108,221</u>

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14. Share Capital (continued)

b) Stock Options

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

	Year ended December 31, 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	2,655,000	1.03	4,355,000	2.82
Exercised	(31,400)	1.22	(1,321,100)	1.48
Expired	-	-	(112,500)	2.56
Forfeited	(1,576,000)	2.77	-	-
Outstanding, end of period	<u>7,734,000</u>	<u>\$ 1.87</u>	<u>6,686,400</u>	<u>\$ 2.24</u>

The following stock options were outstanding at December 31, 2008:

Number of shares	Exercise Price \$	Expiry Date
29,000	0.37	December 2, 2009
30,000	0.80	July 24, 2010
250,000	2.82	October 9, 2010
270,000	1.35	February 5, 2016
250,000	2.29	March 30, 2016
60,000	1.75	May 8, 2016
200,000	1.75	May 22, 2016
35,000	0.85	July 5, 2016
245,000	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
110,000	0.85	January 11, 2017
780,000	2.22	January 11, 2017
50,000	2.75	February 6, 2017
15,000	0.85	April 22, 2017
50,000	0.85	May 31, 2017
50,000	0.85	June 27, 2017
50,000	0.85	July 2, 2017
1,175,000	3.22	July 2, 2017
250,000	2.97	September 23, 2017
25,000	0.85	October 24, 2017
250,000	2.52	February 5, 2018
150,000	1.25	August 25, 2018
1,405,000	0.85	October 5, 2018
850,000	0.85	November 5, 2018
<u>7,734,000</u>		

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14. Share Capital (continued)

During the year, a total of 430,000 stock options were amended, whereby the exercise price was reduced to \$0.85 from \$1.55, \$2.22, \$2.75, \$3.05, \$3.09, \$3.10 and \$3.22. The Company calculated the incremental increase in the fair value of these amended options to be \$76,019 which was charged to operations.

5,404,000 options have vested as at December 31, 2008. The average remaining life of the outstanding options at December 31, 2008 is 8.6 years.

c) Warrants

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

	Year ended December 31, 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
Expired	(1,093,424)	2.30	-	-
Outstanding, end of period	<u>11,063,355</u>	<u>\$ 1.86</u>	<u>16,479,375</u>	<u>\$ 1.89</u>

The following share purchase warrants were outstanding at December 31, 2008:

Number of warrants	Exercise Price \$	Expiry Date
862,117	0.345	June 27, 2010
1,613,238	0.345	November 17, 2010
8,588,000 *	2.300	July 11, 2009
<u>11,063,355</u>		

* During the year, the expiry date for these warrants was extended from July 11, 2008 to July 11, 2009.

d) Stock-Based Compensation

The Company has established a formal stock option plan in accordance with the policies of the TSX Venture Exchange 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 must not be less than the closing market price of the Company's shares on the trading day immediately prior to the date of grant. The options are for a maximum term of ten years.

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 \$1,428 recognized for the year ended December 31, 2008 (December 31, 2007: \$6,974) 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:

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14. Share Capital (continued)

	Year ended December 31, 2008	Year ended December 31, 2007
Risk-free interest rate	2.57% - 3.97%	4.04% - 4.67%
Expected stock price volatility	62% - 78%	59% - 68%
Expected term in years	2, 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.

15. Accumulated other comprehensive income (loss)

Balance at December 31, 2006	\$	-
Cumulative impact of accounting changes, net of tax		449
Adjusted balance January 1, 2007		449
Unrealized (loss) on available-for-sale long term investment, net of tax		(305)
Balance at December 31, 2007		144
Unrealized (loss) on available-for-sale long term investment		(774)
Balance at December 31, 2008	\$	(630)

No future income tax asset has been recorded as a result of this accumulated other comprehensive loss because it is not considered more likely than not that the potential benefits will be realized.

16. Segmented Information

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

	Canada	Peru	Mexico	Other	Total
Year ended December 31, 2008					
Revenue	\$ -	\$ 26,339	\$ -	\$ -	\$ 26,339
Operating (loss) income	\$ (4,548)	\$ (1,003)	\$ (349)	\$ (25)	\$ (5,925)
As at December 31, 2008					
Property, plant & equipment	\$ 5	\$ 11,133	\$ 5,104	\$ 3	\$ 16,245
Total assets	\$ 30,657	\$ 56,401	\$ 50,560	\$ 3,454	\$ 141,072
Year ended December 31, 2007					
Revenue	\$ -	\$ 31,667	\$ -	\$ -	\$ 31,667
Operating (loss) income	\$ (8,836)	\$ 8,972	\$ -	\$ (29)	\$ 107
As at December 31, 2007					
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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(All amounts expressed in thousands of Canadian Dollars, except for share and per share amounts)

17. 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.

Cash and cash equivalents consists of:	December 31, 2008	December 31, 2007
Cash	\$ 2,518	\$ 8,809
Term deposits	33,499	38,431
	<u>\$ 36,017</u>	<u>\$ 47,240</u>

The following non-cash transactions occurred:

	Year ended December 31, 2008	
	Number of shares	Amount
Purchase of resource property on a deferred payment plan	-	\$ 911
Sale of equipment for a long-term receivable	-	151
Fair value of options exercised	-	27

	Year ended December 31, 2007	
	Number of shares	Amount
Shares issued for commission on private placement	422,300	\$ 802
Purchase of equipment on a deferred payment plan	-	847
Fair value of options exercised	-	1,289

18. Commitments and Contingencies

On May 6, 2008, after renegotiating the existing option agreement on the Monte Alban II concession surrounding the San Jose project, Compañía Minera Cuzcatlan SA closed the purchase of a direct 100% interest on this property (Note 10). The purchase price consisted of US\$1,100 paid upon closing, and an additional US\$800 payment due by May 2012 (Note 11).

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. As at December 31, 2008, the Company fulfilled this commitment.

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.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

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

18. Commitments and Contingencies (continued)

The Company acts as guarantor to capital lease obligations held by two of its mining contractors. These capital lease contracts are related to the acquisition of mining equipment deployed at the Caylloma mine. As at December 31, 2008 these obligations amounted to US\$1,330 and mature in 2010.

Environmental Matters

The Company's mining and exploration activities are subject to various laws and regulations governing the protection of the environment. These laws and regulations are continually changing and are generally becoming more restrictive. The Company conducts its operations so as to protect the public health and environment and believes its operations are in compliance with applicable laws and regulations in all material respects. The Company has made, and expects to make in the future, expenditures to comply with such laws and regulations, but cannot predict the full amount of such future expenditures.

Estimated future reclamation costs are based principally on legal and regulatory requirements. As of December 31, 2008 and December 31, 2007, \$1.3 million and \$1.9 million, respectively, were accrued for reclamation costs relating to mineral properties in accordance with Section 3110, "Asset Retirement Obligations". See Note 12.

Income Taxes

The Company operates in numerous countries around the world and accordingly it is subject to, and pays annual income taxes under the various income tax regimes in the countries in which it operates. Some of these tax regimes are defined by contractual agreements with the local government, and others are defined by the general corporate income tax laws of the country. The Company has historically filed, and continues to file, all required income tax returns and to pay the taxes reasonably determined to be due. The tax rules and regulations in many countries are highly complex and subject to interpretation. From time to time the Company is subject to a review of its historic income tax filings and in connection with such reviews, disputes can arise with the taxing authorities over the interpretation or application of certain rules to the Company's business conducted within the country involved.

Title Risk

Although the Company has taken steps to verify title to properties in which it has an interest, these procedures do not guarantee the Company's title. Property title may be subject to, among other things, unregistered prior agreements or transfers and may be affected by undetected defects.

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19. 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.

20. 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 a material effect on the Company's results of operations, financial position or cash flows. The Company has not hedged its exposure to currency fluctuations.

At December 31, 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):

	December 31, 2008		
	US Dollars	Nuevo Soles	Mexican Pesos
Cash and cash equivalents	5,078	629	3,864
Derivatives	1,418	-	-
Accounts receivable	102	10,400	46,460
Long-term receivable	114	-	-
Accounts payable and accrued liabilities	(2,096)	(5,281)	(10,259)
Long-term liability	(876)	-	-
Obligations under capital lease	(1,399)	-	-

Based on the above net exposures as at December 31, 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 \$286 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 \$224 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 \$359 in the Company's net earnings.

FORTUNA SILVER MINES INC.

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FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

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

20. Management of financial risk (continued)

(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 trade accounts receivables are held with a large international metals trading company. The Company has a Mexican value added tax of \$4,026 as at December 31, 2008, of which a significant portion is past due. Additionally, the Company has Peruvian value added tax of \$2,230. The Company expects to recover the full amounts from the Mexican and Peruvian Governments.

(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 by continuing to monitor forecasted and actual cash flows. The Company has in place a planning and budgeting process to help determine the funds required to support the Company's normal operating requirements on an ongoing basis and its development plans. The Company strives to maintain sufficient liquidity to meet its short term business requirements, taking into account its anticipated cash flows from operations, its holdings of cash and cash equivalents and its committed liabilities.

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.

21. Subsequent Events

For the period from January 1, 2009 to March 29, 2009

Acquisition of Continuum Resources Ltd.

On March 6, 2009 the Company closed the acquisition of all the issued and outstanding shares of Continuum Resources Ltd. Continuum had 124,037,920 shares outstanding as of March 6 and the Company has issued to the Continuum shareholders a total of 6,995,738 shares, which is an exchange ratio of approximately 0.0564 of a share of the Company for every one Continuum share held. As Fortuna held 3,706,250 common shares of the issued and outstanding share capital

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

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

21. Subsequent Events (continued)

of Continuum as at March 6, 2009, those shares were cancelled and Fortuna issued a total of 6,786,706 shares to the Continuum shareholders other than Fortuna. As a result of the acquisition of Continuum, Fortuna now owns 100% of the San Jose Project in Oaxaca, Mexico.

The accounting for the acquisition is not yet completed but preliminary estimates have been calculated. The following calculations assume that the cost of acquisition will comprise the fair value of Fortuna shares issued, based on the issuance of 6,786,706 Fortuna shares at \$0.98 per share for consideration of \$6,651. A valuation date of March 6, 2009 was determined for the share value.

The acquisition is being accounted for as a purchase of assets.

The difference between the purchase consideration and the adjusted book values of Continuum's assets and liabilities has been preliminarily assigned to "Mineral properties". The fair value of all identifiable assets and liabilities acquired will be determined by a valuation effective March 6, 2009. Therefore, it is likely that the fair values of assets and liabilities acquired will vary from the amounts shown and the differences may be material. Additional adjustments reflecting any changes in future tax assets or liabilities that would result from recording Continuum's identifiable assets and liabilities at fair value will be made when the process of estimating the fair value of identifiable assets and liabilities is complete.

Purchase price

6,786,706 common shares of Fortuna	\$	6,651
Loan to Continuum		300
Cost of shares previously acquired		185
Total purchase price	\$	7,136

Preliminary estimate of the allocation of purchase price

Cash, accounts receivable and accounts payable	\$	(259)
Mineral properties		10,260
Property, plant & equipment		8
Future income tax liability		(2,873)
Net identifiable assets of Continuum	\$	7,136

Derivatives

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

The following Zinc Forward sale contract was entered into on a SWAP basis:

- USD 1,240/t, for the total of 3,800 tons

The following Lead Forward sale contract was entered into on a SWAP basis:

- USD 1,109/t, for the total of 3,150 tons

SWAP basis contracts are settled against the arithmetic average of zinc spot prices over the month in which the contract matures.

FORTUNA SILVER MINES INC.

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

21. Subsequent Events (continued)

Exercise of stock options

Subsequent to December 31, 2008, the Company received \$20 from the exercise of 23,000 stock options.

Reduction of exploration ground at San Jose

In February 2009 the Company made effective a reduction of 8,344 ha out of the approximately 49,000 ha surrounding the San Jose project for which it holds exploration and mining rights. This is equivalent to a write-down of \$1,072. This decision was based on existing geological information and is part of an effort to prioritize capital expenditures.



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MANAGEMENT'S DISCUSSION AND ANALYSIS Year ended December 31, 2008

General

This Management's Discussion and Analysis ("MD&A") should be read in conjunction with the audited consolidated financial statements of the Company for the years ended December 31, 2008 and 2007, prepared in accordance with Canadian generally accepted accounting principles. This MD&A is prepared as of March 29, 2009. All amounts are expressed in Canadian dollars unless otherwise indicated.

Business of the Company

Fortuna Silver Mines Inc. is a mining company focused on producing silver and developing silver projects in Latin America. The Company's principal assets are the Caylloma poly metallic mine in southern Peru and the San Jose Silver-Gold Project in southern Mexico.

Recent Developments and 2008 Highlights

Financial and Operating Results

In 2008 the Company generated a net loss of \$0.96 million compared to a net loss of \$2.79 million in 2007. For the fourth quarter of 2008 the Company generated a net loss of \$2.53 million compared to a net profit of \$1.41 million in the corresponding period of 2007. Cash generated by operating activities for 2008 was \$8.85 million compared to \$13.24 million in 2007.

In the twelve months concluding December 31, 2008 331,380 tonnes of ore were treated, and metal production amounted to 861,176 ounces of silver, 10,561 MT of zinc, and 7,485 MT of lead. Cash cost per tonne of treated ore for the year was US\$46 and the corresponding unit net smelter return (NSR) was US\$83 (cash cost is a non-GAAP measure. See page 8 for reconciliation of cash cost to the cost of sales in the consolidated statement of operations).

Acquisition of Continuum Resources Ltd. and San Jose project

On March 6, 2009 the Company closed the acquisition of all the issued and outstanding shares of Continuum Resources Ltd. As consideration for the acquisition of Continuum, Fortuna has issued 6,786,706 common shares, for an exchange ratio of approximately 0.0564 of a share of Fortuna for every one Continuum share held.

As a result of the acquisition of Continuum, Fortuna now owns 100% of the San Jose Project in Oaxaca, Mexico. In March 2007, Fortuna published a National Instrument 43-101 compliant resource estimate for San Jose (see Fortuna news release dated March 12, 2007). Using a cut-off grade of 150 g/t silver (Ag) equivalent, the inferred and indicated mineral resources for the Trinidad zone at San Jose are estimated at:

- Indicated Mineral Resources: 1.47 million tonnes grading 262.6 g/t Ag + 2.19 g/t Au containing 17.7 million Ag equivalent oz
- Inferred Mineral Resources: 3.9 million tonnes grading 260.6 g/t Ag + 2.57 g/t Au containing 49.1 million Ag equivalent oz

Fortuna recently completed an extensive drill program designed to convert inferred mineral resources to the measured and indicated categories. The revised resource estimate is expected for June 2009.

The Company has also concluded metallurgical tests for the project with Metcon Research of Tucson, Arizona and is advancing with feasibility level engineering studies for the development of the San Jose deposit. Engineering contracts were awarded in February for mine design, process plant design, tailings dam, water and power. Fortuna expects to present the Environmental Impact Study (EIS) to the Mexican authorities by the end of March.

Management Changes

On February 6, 2008 the Company announced the appointment of Manuel Ruiz-Conejo to the new position of Vice President of Business Development. Mr. Ruiz-Conejo is based in Lima. Effective February 28, 2009 Mark Moseley-Williams stepped down as Vice President of Project Development.

Selected Annual Information

		Twelve month period ended Dec. 2008	Twelve month period ended Dec. 2007	Fifteen month period ended Dec. 2006 (1)
Sales	\$ 000	26,339	31,667	3,372
Income (loss) before income taxes and non-controlling interest	\$ 000	727	1,380	(3,854)
Net loss	\$ 000	(964)	(2,789)	(4,348)
Net loss per share, basic and diluted	\$	(0.01)	(0.04)	(0.12)
Total assets	\$ 000	141,072	124,446	59,194
Total long-term financial liabilities	\$ 000	876	433	97

(1) In August, 2006, Fortuna Silver Mines Inc. (“Fortuna” or the “Company”) changed its fiscal year-end from September 30th to December 31st. As a result of this the period ended December 31, 2006 was a transitional 15 month period.

Quarterly Information

The following table provides information for the most recent eight fiscal quarters to December 31, 2008:

		Quarters Ended							
		31-12-08	30-09-08	30-06-08	31-03-08	31-12-07	30-09-07	30-06-07	31-03-07
Revenues	\$ 000	3,871	7,786	7,848	6,834	7,930	9,201	8,797	5,739
Mine operating income (loss)	\$ 000	(2,860)	1,802	2,876	2,312	3,397	4,097	4,012	1,714
Net Income (loss)	\$ 000	(2,532)	(308)	2,388	(511)	1,411	(3,391)	947	(1,756)
Net Income (loss) per share	- basic and diluted	\$ (0.03)	0.00	0.03	(0.01)	0.02	(0.05)	0.01	(0.03)

Financial Results

During 2008 the Company generated \$26.34 million of sales compared to \$31.67 million in 2007. In US dollar terms which is the currency under which sales take place, there was a decrease of 16.5% in sales for 2008 compared to the previous year. When broken down by type of concentrate; zinc concentrate sales increased in tonnage by 66% while unit value of concentrate decreased 64%. The latter decrease is explained by a reduction in the metal price of 42% and an increase in smelter treatment charges of US\$210 per ton of concentrate. In the case of lead-silver concentrate, sales increased in tonnage by 91% while unit value of concentrate decreased 31%. The latter decrease is the combined result of a decrease in lead price and an increase in silver price of 19% and 12% respectively, and higher smelter treatment charges of US\$330 per ton of concentrate.

The significant increase in concentrate sold is the result of the Company’s continuous investments over the last two years in mine development, processing plant expansion, and infrastructure. As noted below in the Operations section the Company expects this expansion trend to continue. Treatment charges for 2009 have come down significantly, closer to 2007 levels.

During 2008 mine operating income was \$4.13 million and an operating loss was recorded at \$5.93 million. The operating loss reflects the significant decrease in base metal prices which was especially pronounced in the last four months of 2008. The gain from the Company's zinc and lead hedge programme for the year was \$4.52 million, as shown in the income statement under "Net gain on commodity contracts", partially offsetting the decrease in revenues. Net loss for the period was \$0.96 million compared to a net loss of \$2.79 million in 2007. Contributing to the improved net result are the non operating gains, in particular gain on commodity contracts, foreign exchange gain, and a reduced income tax provision generated at our operating subsidiary.

For the last quarter of 2008 the Company recorded a net loss of \$2.53 million compared to a gain of \$1.41 million in the corresponding quarter of 2007. This is mainly explained by a decrease of 28%, 61%, and 55% in silver, lead, and zinc metal prices respectively.

Total **cost of sales** for 2008 was \$22.21 million, of which \$5.68 million was depletion, depreciation, and accretion (2007: \$18.45 million and \$5.77 million respectively). This corresponds entirely to production and sales from Caylloma mine.

Sales and administrative expenses for 2008 totalled \$8.28 million compared to \$6.13 million for 2007. The increase is largely due to higher total corporate expenses associated to the growth of the Company which amounted to \$3.59 million in 2008. The stock based compensation charge totalled \$1.43 million for the year ended December 31, 2008, compared to \$6.97 million for the twelve year ended December 31, 2007.

Interest and other income and expenses amounted to net income of \$1.44 million for 2008 compared to net income of \$1.53 million for 2007. In 2008, this amount consisted principally of \$1.54 million of interest earned, and a \$0.14 million charge for a direct contribution to local governments in the Caylloma mine jurisdiction under a voluntary agreement between the Peruvian Government and the majority of established mining companies in Peru.

Net gain on commodity contract for 2008 was \$4.52 million compared to \$1.56 million in 2007. The result from 2008 was comprised of a \$1.04 million gain on forward lead and zinc contracts entered into with a bank to fix the final settlement price of metal delivered in concentrates, where the final settlement price is yet to be set at a future quotational period according to contract terms, and a gain of \$3.48 million on lead and zinc derivative contracts entered into with a bank as part of a medium-term price protection program.

Interest and finance expenses for 2008 were \$0.10 million compared to \$0.09 million in 2007. These interest expenses relate to capital leases held by our operating subsidiary.

Foreign exchange gain recorded for the year was \$0.84 million, compared to a loss of \$1.67 million for 2007. The Company holds its foreign assets in US and local currencies. Under the temporal method for translation of financial statements which the Company currently uses, gains and losses arising from translation to the Canadian dollar are included in the statement of operations.

Write-off of deferred exploration costs was \$0.35 million in 2008 compared to \$0.01 million for 2007. This is related mainly to a reduction of exploration ground of 2,700 hectares surrounding the San Jose project in Mexico.

The \$1.80 million **Income tax provision** recorded in 2008 (2007: \$4.26 million) consisted of future income tax expense only. Current income tax for 2008 was nil (2007: \$0.54 million including the worker profit sharing plan regulated by Peruvian law). Future income tax expense is mainly related to temporary differences arising on amounts of mineral properties at Peruvian operations where exploration and development are expensed for tax purposes.

Results of Operations

Peru – Caylloma Ag-Pb-Zn Mine

Caylloma Mine

Quarters ended

	31-Dec-08	30-Sep-08	30-Jun-08	31-Mar-08	31-Dec-07	30-Sep-07	30-Jun-07	31-Mar-07
Tonnes milled	91,025	89,827	80,121	70,408	68,615	65,806	63,806	52,687
Average tons milled per day	1,023	1,009	910	800	754	715	701	579
Grade per tonne								
Silver (oz)	3.69	3.14	2.75	2.64	2.43	2.45	2.29	2.23
Lead (%)	2.97	2.58	2.29	1.94	1.87	1.80	1.67	1.39
Zinc (%)	3.75	3.64	3.75	3.42	3.09	3.01	2.92	2.65
Recoveries								
Silver (%)*	82.43	80.07	78.12	76.42	77.74	75.75	73.28	71.39
Lead (%)	93.41	92.19	88.94	87.26	87.51	88.50	89.22	88.59
Zinc (%)	87.25	88.11	87.58	86.45	85.09	86.51	86.22	84.16
Production (metal contained)								
Silver (oz)	291,381	243,280	186,276	140,239	139,433	132,450	119,110	95,473
Lead (tonnes)	2,524	2,139	1,633	1,189	1,124	1,049	952	646
Zinc (tonnes)	2,976	2,877	2,629	2,079	1,805	1,712	1,605	1,178
Unit cash production cost (US\$/tonne)	44.60	44.43	46.92	49.97	52.41	49.15	46.65	42.62
Unit Net Smelter Return (US\$/tonne)	60.00	80.40	97.79	97.70	118.41	133.70	123.65	90.26

* Silver recovery in lead concentrate

In 2008 the Caylloma mine increased throughput by 32% compared to 2007 by processing 319,380 tonne of ore. Silver production increased 77% with respect to 2007 reaching 861,176 oz in 2008. Lead and zinc metal production increased 98.5% and 67.7% respectively. The mill started the year at a 750 tpd throughput rate and closed the year at an average monthly rate of 1,027 tpd. Metallurgical parameters and overall plant performance improved steadily throughout 2008, especially silver recovery in the lead concentrate which reached highs of 83% in November. Our recoveries for lead and zinc, as well as concentrate grade in the lead concentrate, experienced steady increases throughout the year and significant improvements compared to 2007 as shown in the table above.

Mine production throughout the year took place principally on the poly metallic Animas vein which provided 96% of ore sourced to the mill in 2008. Caylloma's silver head grades have been increasing steadily every quarter as a result of the successful discovery and development of high grade silver veins Bateas, Soledad, and Silvia. Production on the "bonanza" grade silver vein Soledad started in late November and already provided close to 10% of production in December. Another contributing factor to the steadily increase in head grades throughout the year has been the development that has taken place along Animas vein which has extended the Central ore shoot in the northeast direction providing good grade zones up to 15 to 20 meter wide. These will be added to reserves in the coming resource update.

During 2008 total underground preparation and development amounted to 13,000 m, a similar figure to the one recorded in 2007. This accumulated mine development and preparation has provided approximately 600,000 tonnes of ore developed and ready to enter production as at the end of 2008. The important flexibility gained in the mine as a result of this will allow the Company to cut back mine development in 2009 to 4,000 m in order to address capital investment reduction needs without affecting short or medium term operations.

Cash production cost per tonne of treated ore evolved from US\$50 for the first quarter of 2008 to US\$45 for the fourth quarter of the year, and the average for 2008 was US\$46. This reduction in unit production costs has been achieved through incremental tonnage and by a reduction in mine preparation costs, especially after the first quarter, as the mine met its targets in terms of ore tonnage prepared ahead of current operation needs.

In late 2007 the Company launched an expansion project to ramp up capacity to 1,200 tpd and the addition of a copper circuit which is scheduled to provide annual incremental income of US\$1.4 million at US\$1.5/lb copper. The expansion project consists of an additional 6x8 ball mill and added zinc flotation cells for total investment costs of US\$460,000. The copper circuit is budgeted at US\$650,000 as well. Both projects are scheduled to be in production in May of 2009.

During the third quarter of 2007 the Company embarked on an investment plan designed to address infrastructure requirements associated with the expansion at Caylloma, and which consisted mainly of a tailings dam expansion, a main extraction level for the Animas vein, and connection to a new power line for increased energy access. The energy project was concluded in February 2008 with a fraction of previous estimated budgets, and securing energy capacity for the scheduled 1,200 tpd expansion. The tailings dam expansion will provide an additional two years of mine life and requires a further budget of US\$600,000. Beyond this a longer lived tailings dam project is currently being taken to the feasibility level. Scoping level estimates suggest a US\$3 million investment for a 10 year life. The main extraction level project at Animas was put on hold in December 2008 after reviewing investment priorities.

The Company is working to produce a resource estimation technical report for Caylloma in June 2009.

Production forecast for Caylloma mine

	2009
Tonnes milled	394,350
Grade per tonne	
Silver (oz)	4.81
Lead (%)	2.65
Zinc (%)	3.58
Copper (%)	0.33
Recoveries	
Silver (%)*	82.00
Lead (%)	92.00
Zinc (%)	86.50
Copper (%)	60.00
Production (metal contained)	
Silver (oz)	1,677,349
Lead (tonnes)	9,621
Zinc (tonnes)	12,207
Copper (tonnes)	574
Unit cash production cost (US\$/tonne)	41.21
Cash cost per ounce (US\$/ounce)	1.86

* Combined silver recoveries in lead and copper concentrates

Cash cost per ounce is net of by-product credits and assumes the following prices: Zn US\$1,100/t, Pb US\$950/t, Cu US\$3,300/t, Au US\$750/oz.

Mexico – San Jose Silver-Gold Project

Trinidad Resource Estimation

On January 2009, the Company completed the 32,000 meter in-fill drilling program initiated in June of 2008. This program was designed to convert inferred resources to the indicated category in the upper 250m of the deposit, where mining is initially expected to take place. Complete assay results for the drill program have been released and are available on the Company's website at www.fortunasilver.com. A new resource estimation is planned to be completed in June 2009.

Metallurgical Studies

Metallurgical tests have now been completed by Metcon Research of Tucson Arizona, and based on these results a definitive process flow sheet is being developed by the Company's metallurgical consultants.

Metallurgical results indicate that commercial grade silver and gold concentrates can be achieved with recoveries over ninety per cent for both metals through a conventional flotation. The use of cyanide is not required as part of this process.

Community Relations and Land Agreements

Over forty hectares of land that encompass the Trinidad mineralized zone and future infrastructure sites have been secured with renewable thirty year land tenure agreements with parcel owners. The Company is currently negotiating a long term collaborative agreement with the San Jose del Progreso Ejido. The Community Relations department continues to engage local and surrounding communities through project presentations, site visits, and sustainable development programs.

Industrial Water Supply

The Company has conducted a positive scoping study on the treatment of "grey water" from an existing plant facility in a nearby town to source the industrial process requirements of the project. Management is moving ahead with the detailed engineering and permitting of this water alternative.

Underground Development

The 1,000 meter long decline to the Trinidad mineralized zone reached the deepest level of the old mine workings, 150 meters below surface, in July of 2008 and was subsequently stopped. Management has achieved the objective of gaining access to the upper portion of the Trinidad zone resource. The decline development to date will allow testing of trial mining methods, gain better geologic control of mineralization and cut down a year's worth of mine preparation time.

Project Engineering

The Company has awarded the following components of the project engineering; plant design and engineering, to Promimet SA de CV, mine design to Proyectos y Estudios Mineros SAC, Geotechnical studies and tailings design to SVS Ingenieros SAC, Energy project to Soto Ortega Ingenieros SA de CV, water project to ICAYS SA de CV. The Company is in the process of selecting a North American engineering firm to provide Qualified Person supervision for the project engineering and to author required Technical Reports.

Permitting

The Company expects to submit the “Manifiesto de Impacto Ambiental” to the Mexican environmental authorities in late March 2009.

Exploration

In February 2009 the Company made effective a reduction of 8,344 ha out of the approximately 49,000 ha surrounding the San Jose project for which it holds exploration and mining rights. This decision was based on existing geological information and is part of an effort to prioritize capital expenditures.

Cash cost per tonne (non-GAAP measures)

Cash cost per tonne is a key performance measure that management uses to monitor performance. These performance measures have no defined meaning within Canadian Generally Accepted Accounting Principles (“Canadian GAAP”), and, therefore, amounts presented may not be comparable to similar data presented by other mining companies.

The following table presents a reconciliation of cash production costs per tonne of processed ore to the cost of sales in the consolidated statement of operations:

	CAD\$ \$'000	US\$ \$'000 @ 0.9375
Cost of sales	22,209	20,820
Change in inventory (ore and concentrate stock piles)	(121)	(113)
Depletion, depreciation, and accretion	(5,681)	(5,326)
Total cash production cost	16,407	15,381
Total processed ore (tonnes)		331,380
Cash production cost per tonne of processed ore (US\$)		46.42

Liquidity and Capital Resources

The Company’s cash resources and liquid investments decreased during the year ended December 31, 2008 by \$11.22 million to \$36.02 million.

For 2008 operating activities generated a net cash amount of \$8.85 million.

During 2008 the Company invested a total amount of \$22.46 million in mineral properties, where investments in Caylloma and San Jose accounted for \$9.43 million and \$13.03 million respectively. Total amount invested in 2008 in plant and equipment was \$3.74 million, where Caylloma and San Jose accounted for \$2.65 million and \$0.94 million respectively. Additionally, the investments in mining properties and projects in Mexico

demanded total value added tax disbursements of \$1.56 million. This value added tax is refundable and is included as part of current assets as at December 31, 2008.

During 2008, Caylloma was successful in self-funding its continued growth in processing and mine capacity. Even under today's metal price environment management expects ongoing and expansion capital needs for 2009 to continue to be self-financed by internally generated cash from operations.

With regards to the San Jose project, management expects investments of US\$6 million in 2009 in order to advance the project to a feasibility level. These investments will be funded through cash reserves.

As at December 31, 2008, the Company had working capital of \$41.64 million compared to working capital of \$51.16 million at December 31, 2007.

Management believes the Company's current financial position as well as results of its ongoing operation in Caylloma is sufficient to support the Company's operating and capital requirements on an ongoing basis. Actual funding requirements may vary from those planned due to further acquisition opportunities. Management believes it will be able to raise equity capital or access debt facilities as required in both the short and long term, but recognizes the uncertainty attached thereto.

Related Party Transactions

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

	Year ended December 31, 2008(\$000)	Year ended December 31, 2007(\$000)
Mineral property costs – geological fees	\$ -	\$ 45
Consulting fees	66	188
Salaries and wages	110	108
Management fees	-	266

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

At December 31, 2008, due to related parties consists of \$46,897 (December 31, 2007 - \$14,000) owing to a company 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.

Critical Accounting Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. These estimates and assumptions are based on established industry standards, historical experience, and are reviewed on an ongoing basis to confirm their continued applicability.

Amortization and Mineral Property Costs

Mineral property costs are comprised of acquisition costs and capitalized exploration, construction and development costs. Upon initiating production, the asset is amortized over its estimated useful life on a units-of-production basis. The Company estimates reserves and resources and the economic life of its mines and utilizes this information to calculate depletion and amortization expense. Depreciation and depletion charges are adjusted prospectively based on periodic re-assessments of the Company's mineral reserves.

The estimate of mineral reserves is prepared by qualified persons in accordance with industry standards defined under NI 43-101 of the Canadian Securities regulatory authorities. Mineral reserve estimates can change over time as a result of numerous factors, including changes in metal prices, production costs, or the re-evaluation of geological, engineering and economic data of a deposit. A significant reduction in mineral reserves would have a negative impact on the calculation of the amortization of this asset.

Asset Retirement Obligations

Fortuna's determination for asset retirement obligations involves estimation of timing and amounts of future costs relating to ongoing environmental and mine closure activities required under applicable law or the Company's own remediation plans. These estimates are subject to significant uncertainties because many of these costs will not be incurred for a number of years, the nature of the reclamation activities might change and the assumptions regarding the rate of inflation and credit risk-adjusted interest rate used in the calculation may vary over time. Therefore, actual costs and their timing might differ from current estimates.

Impairment of Long-lived Assets

Management reviews and evaluates its long-lived assets for impairment when events or changes in circumstances indicate that the related carrying amounts may not be recoverable. Examples of such events or circumstances are changes in metal prices, sudden physical deterioration of the asset, legal circumstances or political risks in the countries Fortuna operates, or other external factors which could have a significant impact on the operations of the Company. Impairment is considered to exist if total estimated future cash flows or probability-weighted cash flows on an undiscounted basis are less than the carrying amount of the assets, including mineral property, plant and equipment and non-producing property. An impairment loss is measured and recorded based on discounted estimated future cash flows or the application of an expected present value technique to estimate fair value in the absence of a market price. Future cash flows include recoverable proven and probable reserves and a portion of recoverable resources, silver, zinc, copper, lead and gold prices (considering current and historical prices, price trends and related factors), production levels, capital and reclamation costs, all based on detailed engineering life-of-mine plans. Assumptions underlying future cash flow estimates are subject to risks and uncertainties. Any differences between significant assumptions and market conditions and/or the Company's performance could have a material effect on any impairment provision, and on the Company's financial position and results of operations.

Income Taxes

The estimation of the Company's future tax liabilities and assets involves significant judgment around a number of assumptions. Judgement must be used to determine the Company's future earning potential, and the expected timing of the reversal of future tax assets and liabilities. Further uncertainties are the result of interpretation of tax legislation in a number of jurisdictions which might differ from the ultimate assessment of the tax authorities. These differences may affect the final amount or the timing of the payment of taxes.

Stock-based Compensation

The determination of the value of stock-based compensation is estimated using the Black-Scholes option pricing model. Option pricing models require the input of highly subjective assumptions, particularly as to the expected price volatility of the stock. Other assumptions include the expected life of the options and the risk-free interest rate at the time of the grant. Changes in these assumptions can materially affect the fair value estimated.

Financial Instruments

The carrying value of receivables, due from/to related parties and accounts payable and accrued liabilities approximate their fair value because of the short-term maturity of those instruments.

The Company enters into derivative contracts to manage its exposure to fluctuations in base metal prices. These contracts are marked-to-market at the end of each period, and the changes in estimated fair value are recorded as an unrealized gain (loss) on commodity contracts in the statement of operations. As at December 31, 2008 the Company estimated the fair value of the outstanding contracts at \$1.73 million, and recorded a gain in the consolidated statements of operations for the 2008 period of \$4.52 million. The estimated fair value was determined based on using applicable valuation techniques for commodity options with reference to the published marked prices for underlying commodities quoted at London Metal Exchange.

The net amount of settled positions on commodity contracts in 2008 was \$4.53 million.

The long-term investments into marketable securities are classified as available-for-sale and are measured at fair value at the end of each period. Fair value of these investments is determined based on published market prices of underlying securities. Change in fair values of available-for-sale marketable securities is recognized in other comprehensive income. During 2008, the Company recorded other comprehensive loss of \$0.69 million relating to change in fair value of marketable securities. This amount is net after tax.

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 December 31, 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):

	December 31, 2008		
	US Dollars	Nuevo Soles	Mexican Pesos
Cash and cash equivalents	5,078	629	3,864
Derivatives	1,418	-	-
Accounts receivable	102	10,400	46,460
Long-term receivable	114	-	-
Accounts payable and accrued liabilities	(2,096)	(5,281)	(10,259)
Long-term liability	(876)	-	-
Obligations under capital lease	(1,399)	-	-

Based on the above net exposures as at December 31, 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 \$286 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 \$224 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 \$359 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 trade accounts receivables are held with a large international metals trading company. The Company has a Mexican value added tax of \$4,026 as at December 31, 2008, of which a significant portion is past due. Additionally, the Company has Peruvian value added tax of \$2,230. The Company expects to recover the full amounts from the Mexican and Peruvian Governments.

(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 by continuing to monitor forecasted and actual cash flows. The Company has in place a planning and budgeting process to help determine the funds required to support the Company's normal operating requirements on an ongoing basis and its development plans. The Company strives to maintain sufficient liquidity to meet its short term business requirements, taking into account its anticipated cash flows from operations, its holdings of cash and cash equivalents and its committed liabilities.

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.

Other Data

Additional information related to the Company is available for viewing at www.sedar.com.

Share Position and Outstanding Warrants and Options

The Company's outstanding share position at March 20, 2009 is 92,141,365 common shares. In addition, a total of 18,774,355 share purchase warrants and incentive stock options are currently outstanding as follows:

<u>Type of Security</u>	<u>No. of Shares</u>	<u>Exercise Price</u>	<u>Expiry Date</u>
Warrants	8,588,000	\$2.30	July 11, 2009
	862,117	\$0.345	June 27, 2010
	<u>1,613,238</u>	\$0.345	Nov. 17, 2010
	11,063,355		
Stock Options:	200,000	\$0.85	April 29, 2009
	20,000	\$1.90	April 29, 2009
	50,000	\$1.96	April 29, 2009
	50,000	\$2.22	April 29, 2009
	100,000	\$3.22	April 29, 2009
	250,000	\$2.97	May 28, 2009
	177,000	\$0.85	May 28, 2009
	29,000	\$0.37	Dec. 2, 2009
	30,000	\$0.80	July 24, 2010
	250,000	\$2.82	Oct. 9, 2010
	270,000	\$1.35	Feb. 5, 2016
	250,000	\$2.29	Mar. 30, 2016
	60,000	\$1.75	May 8, 2016
	200,000	\$1.75	May 22, 2016
	35,000	\$0.85	July 5, 2016
	245,000	\$1.55	July 5, 2016
	860,000	\$1.66	July 10, 2016
	225,000	\$1.61	Sept. 13, 2016
	110,000	\$0.85	Jan. 11, 2017
	730,000	\$2.22	Jan. 11, 2017
	50,000	\$2.75	Feb. 6, 2017
	15,000	\$0.85	April 22, 2017
	50,000	\$0.85	May 31, 2017
	50,000	\$0.85	June 27, 2017
	50,000	\$0.85	July 2, 2017
	1,075,000	\$3.22	July 2, 2017
	25,000	\$0.85	Oct. 24, 2017
250,000	\$2.52	Feb. 5, 2018	
150,000	\$1.25	Aug. 25, 2018	
1,205,000	\$0.85	Oct. 5, 2018	
<u>650,000</u>	\$0.85	Nov. 5, 2018	
7,711,000			

Change in Accounting Policy

Effective January 1, 2008, the Company adopted the following new accounting standards issued by the Canadian Institute of Chartered Accountants:

- a) Section 1535 – Capital Disclosures – Disclosures. Section 1535 requires disclosures of an entity’s objectives, policies and processes for managing capital, and quantitative data about what the entity regards as capital.
- b) Section 3031 – Inventories. Section 3031 requires inventory to be valued on a first-in, first-out or weighted average basis, which is consistent with the Company’s current treatment. The adoption of this standard does not have a material impact on the Company’s Consolidated Financial Statements.
- c) Section 3862 “Financial Instruments – Disclosures” and Section 3863 “Financial Instruments – Presentation”, replace Section 3861 “Financial Instruments – Disclosure and Presentation”. The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and in addition requires companies to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments for the company’s financial position and performance and the nature and extent of risks arising from financial instruments to which the company is exposed during the period and at the balance sheet date, and how the company manages those risks. The new presentation standard carries forward the former presentation requirements.

The Company holds cash balances and incurs payables that are denominated in Canadian Dollars, Mexican Peso and Peruvian Soles. These balances are subject to fluctuations in the exchange rate between the Canadian Dollar, Peruvian Soles and the U.S. Dollar, resulting in currency gains or losses for the Company.

- d) Section 1400 – General Standards of Financial Statement Presentation. Section 1400 was amended to include requirements to assess and disclose an entity’s ability to continue as a going concern.

The adoption of Sections 1535, 3031, 3862, 3863 and 1400 had no impact on the opening equity and losses of the Company.

Recent released Canadian Accounting Standards

The Company has assessed new and revised accounting pronouncements that have been issued that are not yet effective and determined that the following may have an impact on the Company:

Goodwill and Intangible Assets (Section 3064)

In February 2008, the CICA issued section 3064, “Goodwill and Intangible Assets”, which replaces Section 3062, “Goodwill and Intangible Assets,” and CICA Section 3450, “Research and Development Costs,” and CICA Section 1000, “Financial Statement Concepts.” The standard intends to reduce the differences with International Financial Reporting Standards (“IFRS”) in the accounting for intangible assets and results in closer alignment with U.S. GAAP. Under current Canadian standards, more items are recognized as assets than under IFRS or U.S. GAAP. The objectives of CICA Section 3064 are to reinforce the principle-based approach to the

recognition of assets only in accordance with the definition of an asset and the criteria for asset recognition; and clarify the application of the concept of matching revenues and expenses such that the current practice of recognizing assets that do not meet the definition and recognition criteria are eliminated. The standard will also provide guidance for the recognition of internally developed intangible assets (including research and development activities), ensuring consistent treatment of all intangible assets, whether separately acquired or internally developed. This standard will be effective for fiscal years beginning on or after October 1, 2008. The Company is currently evaluating the impact of adopting this standard in 2009.

Business Combinations

In January 2009, the CICA issued Section 1582, Business Combinations, Section 1601, Consolidations, and Section 1602, Non-controlling Interests. These new standards are harmonized with International Financial Reporting Standards (IFRS). Section 1582 specifies a number of changes, including: an expanded definition of a business, a requirement to measure all business acquisitions at fair value, a requirement to measure non-controlling interests at fair value, and a requirement to recognize acquisition-related costs as expenses. Section 1601 establishes the standards for preparing consolidated financial statements. Section 1602 specifies that non-controlling interests be treated as a separate component of equity, not as a liability or other item outside of equity. The new standards will become effective in 2011 but early adoption is permitted. The Company is evaluating the attributes of early adoption of this standard and its potential effects if events or transactions occurred that this standard applies to.

International Financial Reporting Standards

The Canadian Accounting Standards Board has confirmed January 1, 2011 as the date IFRS will replace current Canadian Standards and interpretations as Canadian generally accepted accounting principles (Canadian GAAP) for publicly accountable enterprises. Canadian GAAP will be converged with IFRS over a transition period with an effective implementation date effective for interim and annual periods commencing January 1, 2011. The Company will begin reporting its financial statements in accordance with IFRS on January 1, 2011, with comparative figures for 2010.

The adoption date of January 1, 2011 will require the restatement, for comparative purposes, of amounts reported by the Company for its year ended December 31, 2010, and of the opening balance sheet as at January 1, 2010.

The Company has begun planning its transition to IFRS but the impact on its consolidated financial position and results of operations has not yet been determined. The process will consist of three phases: Scoping and Diagnostics, Analysis and Development, and Implementation and Review. The Company has begun the first phase which includes a diagnostic assessment of its current accounting policies systems and processes in order to identify differences between current Canadian GAAP and IFRS treatment. The Company will continue to monitor changes in IFRS during implementation process and intends to update the critical accounting policies and procedures to incorporate the changes required by converting to IFRS and the impact of these changes on its financial reporting.

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, and performance of achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others, changes in project parameters to deal with unanticipated economic factors, risks related to technological and operational nature of the Company's business, the speculative nature of exploration and development, changes in local and national government legislation

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 in the section Risks and Uncertainties.

In particular, forward-looking information and statements include:

- Production forecast for 2009.
- Cash cost per ton of treated ore and cash cost per ounce of payable silver for 2009.
- Throughput expansion and copper circuit projects are scheduled to be in production in May of 2009.
- Scheduled annual incremental income of the copper circuit project.
- Conclusion of the Caylloma resource estimation.
- Conclusion of the San Jose resource estimation.
- Management expects ongoing and expansion capital needs for 2009 at Caylloma to continue to be self-financed by internally generated cash from operations.
- Management expects investments of US\$6 million in 2009 at San Jose in order to advance the project to a feasibility level.

Risks and Uncertainties

Metal prices

One of the most significant risks affecting the profitability and viability of the Company's mining operations is the fluctuation of metal prices. Volatility of metal prices is high by historic measures and strong downturns on these prices can have significant adverse effects on the continuity of the Company's operations. In order to mitigate this risk in the medium term, the Company put in place price protection strategies for approximately 50% of its zinc and lead metal production during twelve months from the original contract dates up to January 2009. Subsequently the Company extended the price protection for 65% of zinc and lead production between the months of February and July of 2009.

Credit risk

The Company is subject to credit risk through its trade receivables. The Company enters in one year contracts to sell its concentrate products at Caylloma and transacts only with credit worthy costumers to minimize credit risk. The Company has awarded its full production of 2009 to Swiss metal trader Glencore International.

The Company holds derivative contracts with financial institutions and in this regard is exposed to counterparty risk. The Company mitigates this risk by transacting only with credit worthy costumers to minimize credit risk. The Company currently holds derivatives contracts with Standard Bank PLC. and BBVA SA.

Environmental risk

The Company has recorded an asset retirement obligation of \$1,30 million as of December 31, 2008. 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 is currently working on a new estimate.

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.

Exchange rate risk

The Company's reporting currency is the Canadian dollar, however the Company's foreign assets as well as most of its commercial transactions are held and take place in US and local currencies. As a consequence, the financial results of the Company's operations as reported in Canadian dollars are subject to changes in value of the Canadian dollar relative to US and local currencies.

Exploration and development

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. Major expenses may be required to establish reserves by drilling and to construct mining and processing facilities at a site. It is impossible to ensure that exploration and development programs carried out by the Company will result in profitable commercial mining operations.

Resources and reserves

There is a degree of uncertainty attributable to the calculation of resources and reserves and to expected mineral grades. Mineral Resource and Mineral Reserves may require revision based on actual production experience. Market fluctuations in the price of metals, as well as increased production costs and reduced recovery rates, may render certain mineral reserves uneconomic and may ultimately result in a restatement of resources and/or reserves. Short-term operating factors relating to the mineral resources and reserves, such as the need for sequential development of ore bodies may adversely affect the Company's profitability in any accounting period.

Political and country risk

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.

The State of Oaxaca has a history of social conflicts and political agitation which can lead to public demonstrations and blockades that can from time to time affect the Company's operations.

Considerations in Light of the Credit Crisis and General State of the Markets

The significant decline in the prices of silver, zinc and lead during the last four months of 2008 has had a negative impact on the Company's profitability. In Q4 2008, the strengthening of the U.S. dollar relative to the Canadian dollar partially offset this negative impact. With the current global economic uncertainty, the Company anticipates that commodity prices will remain depressed and the Canadian-U.S. dollar exchange rate will remain volatile in the near term. Based on current metal prices, the current value of the U.S. dollar, and planned production levels, and after the effects of negative price adjustments as discussed, the Company expects to resume generating positive cash flows in the first half of 2009, albeit at significantly lower levels than earlier in 2008.

In light of the current market environment, the Company's near-term goal is to preserve its cash balances to the greatest extent possible, by minimizing operating costs and by curtailing capital expenditures. In that regard, the Company is currently reviewing its operations in Peru with a view to optimizing efficiencies and reducing costs wherever possible without compromising safety, health or environmental standards. The Company will be monitoring market conditions and the planned capital budget for the Mexican operations with a view to determining an optimal development schedule given the Company's current cash balances, its ability to generate sufficient cash flows, and its ability to obtain additional funding in the current market environment. Additional funding may include external debt financing, or the public or private sales of equity or debt securities of the Company.

The Company has assessed the carrying values of its mineral properties as a result of the market downturn. In the last few months, declining metal prices as a result of the global economic uncertainty, and negative market sentiment have lead to the Company's market capitalization dropping below its book value as at December 31, 2008. Based on current and expected metal prices and cost structures, management has determined that the values of the Company's mineral properties have not been impaired at this time. However, should current

market conditions and commodity prices worsen and/or persist for a prolonged period of time, an impairment of mineral properties may be required.

Internal Disclosure Controls and Procedures

During 2008 the Company engaged an external consulting firm to assist Fortuna's management in documenting and assessing the design effectiveness of Internal Control over Financial Reporting on its main business and accounting processes. This is an ongoing effort.

The Company evaluated the effectiveness of the design and operation of the disclosure controls and procedures as of December 31, 2008 under the supervision of the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO"). Based on the results of this evaluation the CEO and the CFO have concluded that such disclosure controls are sufficiently effective to provide reasonable assurance that material information relating to the Company is made known to management and disclosed in accordance with the applicable securities laws.

Management is responsible for establishing a system of internal control over financial reporting to provide reasonable assurance regarding the reliability and integrity of the Company's financial information and the preparation of its financial statements in accordance with Canadian generally accepted accounting principles. Management of the Company has evaluated the effectiveness of internal control over financial reporting as of December 31, 2008 and has concluded there are no material weaknesses. Management continues to review and refine its internal controls and procedures.