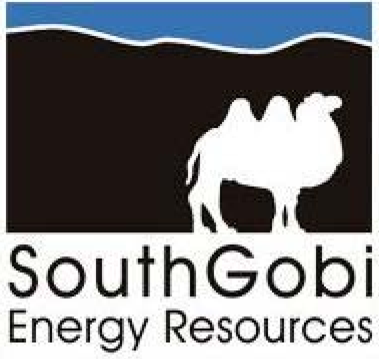


# SouthGobi Energy Resources Ltd.
## CONSOLIDATED INTERIM FINANCIAL STATEMENTS
## June 30, 2009
(Unaudited)
(Stated in U.S. dollars)

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# SOUTHGOBI ENERGY RESOURCES LTD.
## Consolidated Interim Statement of Comprehensive Income
(Unaudited)
(Stated in U.S. dollars)

| | Notes | Three months ended June 30, 2009 | Three months ended June 30, 2008 | Six months ended June 30, 2009 | Six months ended June 30, 2008 |
|---|---|---|---|---|---|
| **Continuing operations** | | | | | |
| Revenue | | **$ 10,666,362** | $ - | **$ 14,206,958** | $ - |
| Cost of sales | 7 | **(9,138,686)** | - | **(12,352,001)** | - |
| **Income from mine operations** | | **1,527,676** | - | **1,854,957** | - |
| Administration expenses | 8 | **(4,444,560)** | (1,405,611) | **(10,549,533)** | (2,512,057) |
| Evaluation and exploration expenses | 9 | **(4,640,516)** | (10,363,134) | **(8,770,667)** | (16,737,641) |
| **Operating loss from continuing operations** | | **(7,557,400)** | (11,768,745) | **(17,465,243)** | (19,249,698) |
| Finance costs | 10 | **(355,722)** | - | **(417,621)** | (7,955,993) |
| Interest income | | **2,922** | 580,055 | **12,374** | 1,108,312 |
| **Loss before tax** | | **(7,910,200)** | (11,188,690) | **(17,870,490)** | (26,097,379) |
| Income tax expense | | **-** | - | **-** | - |
| **Loss from continuing operations** | | **(7,910,200)** | (11,188,690) | **(17,870,490)** | (26,097,379) |
| Loss from discontinued operations | 6 | **-** | (2,392,568) | **-** | (3,695,230) |
| **Net loss and comprehensive loss attributable to equity holders of the Company** | | **$ (7,910,200)** | $ (13,581,258) | **$ (17,870,490)** | $ (29,792,609) |
| **Basic and diluted loss per share from:** | | | | | |
| Continuing operations | 11 | **(0.06)** | (0.09) | **(0.13)** | (0.20) |
| Discontinued operations | 11 | **-** | (0.02) | **-** | (0.03) |
| **Continuing and discontinued operations** | | **(0.06)** | (0.11) | **(0.13)** | (0.23) |
| Weighted average number of basic and diluted shares outstanding | 11 | **133,352,408** | 131,488,263 | **133,307,891** | 130,867,406 |

**The accompanying notes are an intergral part of these Consolidated Interim Financial Statements.**

# SOUTHGOBI ENERGY RESOURCES LTD.

## Consolidated Interim Statement of Financial Position

(Unaudited)
(Stated in U.S. dollars)

| | Notes | As at June 30, 2009 | As at December 31, 2008 | As at December 31, 2007 |
|---|---|---|---|---|
| **Assets** | | | | |
| **Current assets** | | | | |
| Cash and cash equivalents | | **$ 2,806,299** | $ 10,117,311 | $ 1,393,632 |
| Trade and other receivables | | **17,368,541** | 7,289,726 | 759,528 |
| Inventories | 12 | **11,445,852** | 13,676,716 | - |
| Prepaid expenses and deposits | | **3,913,412** | 2,578,527 | 1,890,177 |
| | | **35,534,104** | 33,662,280 | 4,043,337 |
| Assets classified as held for sale | 6 | **-** | 637,600 | - |
| **Total current assets** | | **35,534,104** | 34,299,880 | 4,043,337 |
| **Non-current assets** | | | | |
| Property, plant and equipment | 14 | **65,236,480** | 52,439,911 | 1,123,380 |
| Intangible assets | 13 | **13,208,218** | 13,208,218 | 443,360 |
| Other assets | | **54,167** | - | - |
| **Total non-current assets** | | **78,498,865** | 65,648,129 | 1,566,740 |
| **Total assets** | | **$ 114,032,969** | $ 99,948,009 | $ 5,610,077 |
| **Equity and liabilities** | | | | |
| **Current liabilities** | | | | |
| Trade and other payables | | **$ 8,000,191** | $ 7,400,009 | $ 1,767,784 |
| Amount due under line of credit facilities | 15 | **24,397,695** | - | - |
| Deposit received for sale of metals division | 6 | **-** | 3,000,000 | - |
| | | **32,397,886** | 10,400,009 | 1,767,784 |
| Current liabilities classified as held for sale | 6 | **-** | 255,080 | - |
| **Total current liabilities** | | **32,397,886** | 10,655,089 | 1,767,784 |
| **Non-current liabilities** | | | | |
| Amount due under line of credit facilities | 15 | **-** | - | 105,673,380 |
| Asset retirement obligation | 16 | **425,898** | 328,229 | - |
| **Total non-current liabilities** | | **425,898** | 328,229 | 105,673,380 |
| **Total liabilities** | | **32,823,784** | 10,983,318 | 107,441,164 |
| **Shareholders' equity (deficiency)** | | | | |
| Common shares | 17 | **290,175,383** | 289,512,074 | 30,229,785 |
| Preferred shares | 17 | **-** | - | 4,189,154 |
| Share option reserve | 18 | **19,609,271** | 12,775,076 | 7,496,691 |
| Accumulated deficit | 19 | **(228,575,469)** | (213,322,459) | (143,746,717) |
| **Total shareholders' equity (deficiency)** | | **81,209,185** | 88,964,691 | (101,831,087) |
| **Total equity and liabilities** | | **$ 114,032,969** | $ 99,948,009 | $ 5,610,077 |

**The accompanying notes are an intergral part of these Consolidated Interim Financial Statements.**

**APPROVED BY THE BOARD:**

*"Andre Deepwell"*
Director

*"Pierre Lebel"*
Director

# SOUTHGOBI ENERGY RESOURCES LTD.
## Consolidated Interim Statement of Changes in Equity
(Unaudited)
(Stated in U.S. dollars)

| | Common Shares | | Preferred Shares | | | | |
|---|---|---|---|---|---|---|---|
| | Number of shares | Amount | Number of shares | Amount | Share option reserve | Accumulated deficit | Total |
| Balances, January 1, 2008 | 74,932,657 | $ 30,229,785 | 25,576,383 | $ 4,189,154 | $ 7,496,691 | $ (143,746,717) | $ (101,831,087) |
| Shares issued for: | | | | | | | |
| Cash | 16,211,111 | 139,642,368 | - | - | - | - | 139,642,368 |
| Share issue costs | - | (3,303,418) | - | - | - | - | (3,303,418) |
| Mineral property | 321,818 | 5,198,000 | - | - | - | - | 5,198,000 |
| Conversion of line of credit | 14,709,071 | 107,551,903 | - | - | - | - | 107,551,903 |
| Conversion of preferred shares | 25,576,383 | 4,189,154 | (25,576,383) | (4,189,154) | - | - | - |
| Exercise of stock options | 1,442,242 | 6,004,282 | - | - | (1,960,086) | - | 4,044,196 |
| Stock-based compensation charged to operations | - | - | - | - | 7,238,471 | - | 7,238,471 |
| Net loss and comprehensive loss for the year | - | - | - | - | - | (69,575,742) | (69,575,742) |
| Balances, December 31, 2008 | 133,193,282 | $ 289,512,074 | - | $ - | $ 12,775,076 | $ (213,322,459) | $ 88,964,691 |
| Shares issued for: | | | | | | | |
| Exercise of stock options | 174,100 | $ 663,309 | - | $ - | $ (283,574) | $ - | $ 379,735 |
| Stock-based compensation charged to operations | - | - | - | - | 7,117,769 | - | 7,117,769 |
| Gain on sale of metals division | - | - | - | - | - | 2,617,480 | 2,617,480 |
| Net loss and comprehensive loss for the period | - | - | - | - | - | (17,870,490) | (17,870,490) |
| **Balances, June 30, 2009** | **133,367,382** | **$ 290,175,383** | **-** | **$ -** | **$ 19,609,271** | **$ (228,575,469)** | **$ 81,209,185** |
| | | | | | | | |
| Balances, January 1, 2008 | 74,932,657 | $ 30,229,785 | 25,576,383 | $ 4,189,154 | $ 7,496,691 | $ (143,746,717) | $ (101,831,087) |
| Cash | 16,211,111 | 139,583,167 | - | - | - | - | 139,583,167 |
| Share issue costs | - | (3,244,217) | - | - | - | - | (3,244,217) |
| Conversion of line of credit | 14,709,071 | 107,551,903 | - | - | - | - | 107,551,903 |
| Conversion of preferred shares | 25,576,383 | 4,189,154 | (25,576,383) | (4,189,154) | - | - | - |
| Exercise of stock options | 1,209,628 | 4,841,574 | - | - | (1,505,060) | - | 3,336,514 |
| Stock-based compensation charged to operations | - | - | - | - | 2,908,665 | - | 2,908,665 |
| Net loss and comprehensive loss for the period | - | - | - | - | - | (29,792,609) | (29,792,609) |
| Balances, June 30, 2008 | 132,638,850 | $ 283,151,366 | - | $ - | $ 8,900,296 | $ (173,539,326) | $ 118,512,336 |

**The accompanying notes are an intergral part of these Consolidated Interim Financial Statements.**

# SOUTHGOBI ENERGY RESOURCES LTD.

## Consolidated Interim Statement of Cash Flows

(Unaudited)
(Stated in U.S. dollars)

| | Notes | Three months ended June 30, 2009 | Three months ended June 30, 2008 | Six months ended June 30, 2009 | Six months ended June 30, 2008 |
|---|---|---|---|---|---|
| **Operating activities** | | | | | |
| Loss for the period from continuing operations | | **$ (7,910,200)** | $ (11,188,690) | **$ (17,870,490)** | $ (26,097,379) |
| Adjustments for: | | | | | |
| Depreciation and depletion | | **1,626,223** | 54,495 | **2,047,538** | 133,707 |
| Share-based compensation | | **3,270,700** | 1,118,141 | **7,117,769** | 2,020,285 |
| Fair value change on embedded derivative | | **-** | - | **-** | 7,223,399 |
| Interest income | | **(2,922)** | (580,055) | **(12,374)** | (1,108,312) |
| Accrued interest expense | | **344,955** | - | **397,695** | 134,186 |
| Interest accretion on line of credit facility | | **-** | - | **-** | 598,408 |
| Unrealized foreign exchange loss/(gain) | | **129,024** | (918,576) | **1,196,630** | (1,369,982) |
| Loss on disposal of property, plant and equipment | | **(284)** | - | **112,920** | 3,004 |
| Accretion of asset retirement obligation | | **10,767** | 5,111 | **19,926** | 5,111 |
| Operating cash flows before movements in working capital | | **(2,531,737)** | (11,509,574) | **(6,990,386)** | (18,457,573) |
| Decrease/(increase) in inventories | | **3,630,439** | (3,148,755) | **2,902,378** | (3,148,755) |
| Increase in trade and other receivables | | **(8,740,146)** | (1,378,049) | **(11,649,324)** | (2,863,066) |
| Increase in prepaid expenses and deposits | | **(341,814)** | (1,698,324) | **(1,334,885)** | (3,980,117) |
| Increase in trade and other payables | | **1,300,646** | 4,311,284 | **974,939** | 4,171,235 |
| Cash used in continuing operations | | **(6,682,612)** | (13,423,418) | **(16,097,278)** | (24,278,276) |
| Cash used in discontinued operations | 6 | **-** | (2,352,596) | **-** | (2,862,548) |
| **Cash used in operating activities** | | **$ (6,682,612)** | $ (15,776,014) | **$ (16,097,278)** | $ (27,140,824) |
| | | | | | |
| **Investing activities** | | | | | |
| Purchase of property, plant and equipment | | **$ (10,021,097)** | $ (23,970,083) | **$ (15,576,473)** | $ (37,267,286) |
| Purchase of mineral properties | | **-** | (2,137,915) | **-** | (2,137,915) |
| Interest received | | **2,921** | 580,055 | **22,216** | 1,108,312 |
| Proceeds from disposal of property, plant and equipment | | **25,675** | - | **25,675** | - |
| Increase in other assets | | **(54,167)** | - | **(54,167)** | - |
| Cash used in continuing operations | | **(10,046,668)** | (25,527,943) | **(15,582,749)** | (38,296,889) |
| Cash used in discontinued operations | 6 | **-** | (14,323) | **-** | (15,510) |
| **Cash used in investing activities** | | **$ (10,046,668)** | $ (25,542,266) | **$ (15,582,749)** | $ (38,312,399) |
| | | | | | |
| **Financing activities** | | | | | |
| Proceeds from issuance of common shares, warrants and exercise of stock options | | **$ 157,571** | $ 26,031,098 | **$ 379,735** | $ 139,675,465 |
| Drawings under line of credit facility | 15 | **16,000,000** | - | **24,000,000** | 2,000,000 |
| Repayment of line of credit facility | | **-** | - | **-** | (8,077,470) |
| **Cash generated from financing activities** | | **$ 16,157,571** | $ 26,031,098 | **$ 24,379,735** | $ 133,597,995 |
| | | | | | |
| Effect of foreign exchange rate changes on cash | | **(26,836)** | 901,766 | **(10,720)** | 1,394,480 |
| | | | | | |
| **Increase/(decrease) in cash and cash equivalents** | | **(598,545)** | (14,385,416) | **(7,311,012)** | 69,539,252 |
| Cash and cash equivalents, beginning of period | | **3,404,844** | 85,318,300 | **10,117,311** | 1,393,632 |
| **Cash and cash equivalents, end of period** | | **$ 2,806,299** | $ 70,932,884 | **$ 2,806,299** | $ 70,932,884 |
| | | | | | |
| **Comprised of:** | | | | | |
| Cash and cash equivalents of continuing operations | | **$ 2,806,299** | $ 70,723,777 | **$ 2,806,299** | $ 70,723,777 |
| Cash and cash equivalents of discontinued operations | | **-** | 209,107 | **-** | 209,107 |
| **Total cash and cash equivalents** | | **$ 2,806,299** | $ 70,932,884 | **$ 2,806,299** | $ 70,932,884 |
| | | | | | |
| Cash | | **$ 2,806,299** | $ 9,619,619 | **$ 2,806,299** | $ 9,619,619 |
| Money market instruments | | **-** | 61,313,265 | **-** | 61,313,265 |
| **Total cash and cash equivalents** | | **$ 2,806,299** | $ 70,932,884 | **$ 2,806,299** | $ 70,932,884 |

**Supplemental cash flow information (Note 22)**

**The accompanying notes are an intergral part of these Consolidated Interim Financial Statements.**

## 1. CORPORATE INFORMATION

SouthGobi Energy Resources Ltd. is a publicly listed company incorporated in Canada with limited liability under the legislation of the Province of British Columbia and its shares are listed on the TSX Venture Exchange. The company together with its subsidiaries (collectively referred to as the "Company") is principally engaged in the acquisition, exploration, development and production of coal properties in Mongolia and Indonesia. The Company's parent is Ivanhoe Mines Ltd. (the "parent" or "Ivanhoe").

The head office, principal address and registered and records office of the Company are located at 999 Canada Place, Suite 654, Vancouver, British Columbia, V6C 3E1.

The Consolidated Interim Financial Statements are presented in U.S. dollars and all values are rounded to the nearest dollar except where otherwise indicated.

The Company is a coal producer and a coal exploration and development company. These Consolidated Interim Financial Statements have been prepared on a going concern basis, which contemplates the realization of assets and settlement of liabilities in the normal course of business. The Company has incurred losses since inception and has an accumulated deficit of $228,575,469. The Company's ability to continue as a going concern is dependent upon establishing profitable operations, the confirmation of economically recoverable reserves and the ability to obtain further financing to develop properties.

Management is of the opinion that additional financing will be available to continue its planned activities in the normal course of its operations. To date, a portion of the additional financing has been provided by Ivanhoe. There can, however, be no assurance the Company will be able to raise sufficient funds in the future.

These financial statements do not give effect to adjustments that may be necessary should the Company be unable to continue as a going concern.

In December 2008, the Company announced that it had sold its Metals Division to Ivanhoe Mines Ltd. for $3 million. The sale was effective December 30, 2008 and closed on February 2, 2009. The Metals Division consisted of certain base and precious metals properties in Mongolia and Indonesia. The Company will now be focused solely on coal production, development and exploration.

## 2. BASIS OF PREPARATION

### 2.1 Statement of compliance

These Consolidated Interim Financial Statements are unaudited and have been prepared in accordance with IAS 34 '*Interim Financial Reporting*' ("IAS 34") using accounting policies consistent with the International Financial Reporting Standards ("IFRS") issued by the International Accounting Standards Board ("IASB") and Interpretations of the International Financial Reporting Interpretations Committee ("IFRIC").

These are the Company's second IFRS Consolidated Interim Financial Statements for part of the period covered by the Company's first IFRS Consolidated Annual Financial Statements for the year ending December 31, 2009. Previously, the Company prepared its Consolidated Annual and Consolidated Interim Financial Statements in accordance with Canadian Generally Accepted Accounting Principles ("GAAP").

As these are the Company's second set of Consolidated Interim Financial Statements in accordance with IFRS, the Company's disclosures exceed the minimum requirements under IAS 34. The Company has elected to exceed the minimum requirements in order to present the Company's accounting policies in accordance with IFRS and the additional disclosures required under IFRS, which also highlight the changes from the Company's 2008 annual Consolidated Financial Statements prepared in accordance with Canadian GAAP. In 2010 and beyond, the Company may not provide the same amount of disclosure in the Company's Consolidated Interim Financial Statements under IFRS as the reader will be able to rely on the annual consolidated financial statements which will be prepared in accordance with IFRS.

### 2.2 Basis of presentation

The Consolidated Interim Financial Statements have been prepared on the historical cost basis except for certain non-current assets and financial instruments, which are measured at fair value, as explained in the accounting policies set out in Note 4. The comparative figures presented in these Consolidated Interim Financial Statements are in accordance with IFRS and have not been audited.

## 2. BASIS OF PREPARATION (Continued)

### 2.3 Adoption of new and revised standards and interpretations

The IASB issued a number of new and revised International Accounting Standards, International Financial Reporting Standards, amendments and related interpretations which are effective for the Company's financial year beginning on or after January 1, 2009. For the purpose of preparing and presenting the financial information for the relevant periods, the Company has consistently adopted all these new standards for the relevant reporting periods.

At the date of authorization of these Financial Statements, the IASB and IFRIC has issued the following new and revised Standards and Interpretations which are not yet effective for the relevant reporting periods.

- IFRS 2 (Revised) *'Share Based Payments'* – Clarification of scope of IFRS 2 (Revised) (i)
- IFRS 3 (Revised) *'Business Combinations'* – Amendments to accounting for business combinations (i)
- IFRS 5 (Revised) *'Non-current Assets Held for Sale and Discontinued Operations'* – Plan to sell the controlling interest in a subsidiary (i)
- IFRS 5 (Revised) *'Non-current Assets Held for Sale and Discontinued Operations'* – Disclosure on non-current assets classified as held for sale or discontinued operations (ii)
- IFRS 8 *'Operating* Segments' – Disclosure on information about segment assets (ii)

(i) Effective for annual periods beginning on or after July 1, 2009
(ii) Effective for annual periods beginning on or after January 1, 2010

The Company has not early adopted these standards, amendments and interpretations, however the Company is currently assessing what impact the application of these standards or amendments will have on the Consolidated Financial Statements of the Company.

## 3. FIRST TIME ADOPTION OF IFRS

The Company has adopted IFRS on January 1, 2009 with a transition date of January 1, 2005. Under IFRS 1 *'First-time Adoption of International Financial Reporting Standards'*, the IFRS are applied retrospectively at the transition date with all adjustments to assets and liabilities as stated under GAAP taken to retained earnings unless certain exemptions are applied. The Company is not applying any exemptions on first-time adoption of IFRS.

Below is the Company's Consolidated Statement of Financial Position as at the transition date of January 1, 2005 under IFRS.

| | As at January 1, 2005 (Unaudited) |
|---|---|
| **Assets** | |
| **Current assets** | |
| Cash and cash equivalents | $ 8,222,182 |
| Trade and other receivables | 79,737 |
| Prepaid expenses and deposits | 124,276 |
| **Total current assets** | 8,426,195 |
| **Non-current assets** | |
| Property, plant and equipment | 149,382 |
| Intangible assets | 158,384 |
| **Total non-current assets** | 307,766 |
| **Total assets** | $ 8,733,961 |
| **Equity and liabilities** | |
| **Current liabilities** | |
| Trade and other payables | $ 1,035,404 |
| **Total current liabilities** | 1,035,404 |
| **Total liabilities** | 1,035,404 |
| **Shareholders' equity** | |
| Common shares | 14,183,003 |
| Additional paid in capital | 1,690,842 |
| Share option reserve | 996,330 |
| Accumulated deficit | (9,171,618) |
| **Total shareholders' equity** | 7,698,557 |
| **Total equity and liabilities** | $ 8,733,961 |

## 3. FIRST TIME ADOPTION OF IFRS (Continued)

IFRS employs a conceptual framework that is similar to Canadian GAAP. While the adoption of IFRS has not changed the actual cash flows of the Company, the adoption has resulted in significant changes to the reported financial position and results of operations of the Company. Presented below are reconciliations prepared by the Company to reconcile to IFRS the assets, liabilities, equity, net loss and cash flows of the Company from those reported under Canadian GAAP:

### 3.1 Total assets

| | | At December 31, | | | | At January 1, |
|---|---|---|---|---|---|---|
| | Notes | 2008 | 2007 | 2006 | 2005 | 2005 |
| Total assets under Canadian GAAP | | $ 100,132,144 | $ 5,610,077 | $ 2,052,235 | $ 3,774,953 | $ 8,699,107 |
| Adjustments for differing accounting treatments: | | | | | | |
| - Inclusion of coal division assets | (i) | - | - | 262,688 | 143,641 | 34,854 |
| - Adjustment for asset retirement obligation | (v) | (184,135) | - | - | - | - |
| **Total assets under IFRS** | | $ 99,948,009 | $ 5,610,077 | $ 2,314,923 | $ 3,918,594 | $ 8,733,961 |

### 3.2 Total liabilities

| | | At December 31, | | | | At January 1, |
|---|---|---|---|---|---|---|
| | Notes | 2008 | 2007 | 2006 | 2005 | 2005 |
| Total liabilities under Canadian GAAP | | $ 11,167,453 | $ 36,875,588 | $ 6,287,041 | $ 692,699 | $ 1,035,404 |
| Adjustments for differing accounting treatments: | | | | | | |
| - Fair value of embedded derivative on debt | (ii) | 107,551,903 | 70,565,576 | - | - | - |
| - Conversion of debt | (ii) | (107,551,903) | - | - | - | - |
| - Adjustment for warrant liability | (iv) | - | - | 221,641 | 221,641 | - |
| - Conversion of warrant liability | (iv) | - | - | (221,641) | - | - |
| - Adjustment for asset retirement obligation | (v) | (184,135) | - | - | - | - |
| **Total liabilities under IFRS** | | $ 10,983,318 | $ 107,441,164 | $ 6,287,041 | $ 914,340 | $ 1,035,404 |

### 3.3 Total equity (deficiency)

| | | At June 30, | At December 31, | | | | At January 1, |
|---|---|---|---|---|---|---|---|
| | Notes | 2008 | 2008 | 2007 | 2006 | 2005 | 2005 |
| Total equity (deficiency) under Canadian GAAP | | $ 118,512,336 | $ 88,964,691 | $ (31,265,512) | $ (4,234,806) | $ 3,082,254 | $ 7,663,703 |
| Adjustments for differing accounting treatments: | | | | | | | |
| - Inclusion of coal division results, net of contribution by Ivanhoe | (i) | - | - | - | 262,688 | 143,641 | 34,854 |
| - Fair value of embedded derivative on debt | (ii) | (107,551,903) | (107,551,903) | (70,565,575) | - | - | - |
| - Conversion of debt | (ii) | 107,551,903 | 107,551,903 | - | - | - | - |
| - Adjustment for warrant liability | (iv) | - | - | - | - | (221,641) | - |
| **Total equity (deficiency) under IFRS** | | $ 118,512,336 | $ 88,964,691 | $ (101,831,087) | $ (3,972,118) | $ 3,004,254 | $ 7,698,557 |

## 3. FIRST TIME ADOPTION OF IFRS (Continued)

### 3.4 Net loss

| | Notes | Three months ended June 30, 2008 | Six months ended June 30, 2008 | Year ended December 31, 2008 | 2007 | 2006 | 2005 |
|---|---|---|---|---|---|---|---|
| Net loss and comprehensive loss for the period under Canadian GAAP | | $ 13,488,289 | $ 22,026,873 | $ 62,385,848 | $ 26,729,932 | $ 9,361,815 | $ 6,213,957 |
| Basic and Diluted Loss per Share under Canadian GAAP | | $ 0.10 | $ 0.17 | $ 0.49 | $ 0.52 | $ 0.56 | $ 0.41 |
| Adjustments for differing accounting treatments: | | | | | | | |
| - Inclusion of coal division results | (i) | - | - | - | 2,546,368 | 12,167,928 | 9,923,018 |
| - Fair value of embedded derivative on debt | (ii) | - | 7,223,400 | 7,223,400 | 63,286,039 | - | - |
| - Interest accretion on line of credit facility | (ii) | - | 319,360 | 319,360 | 4,224,179 | - | - |
| - Adjustments on stock based compensation | (iii) | 92,969 | 222,976 | (352,866) | (50,089) | (250,730) | (107,301) |
| - Adjustment for warrant liability | (iv) | - | - | - | - | 449,623 | 80,361 |
| **Net loss and comprehensive loss for period under IFRS** | | $ 13,581,258 | $ 29,792,609 | $ 69,575,742 | $ 96,736,429 | $ 21,728,636 | $ 16,110,035 |
| **Basic and Diluted Loss per Share under IFRS** | | $ 0.11 | $ 0.23 | $ 0.54 | $ 1.89 | $ 1.31 | $ 1.06 |

### 3.5 Cash flows

The adoption of IFRS has had no impact on the net cash flows of the Company. The changes made to the Consolidated Statements of Financial Position and Consolidated Statements of Comprehensive Income have resulted in reclassifications of various amounts on the Consolidated Statements of Cash Flows, however as there have been no changes to the net cash flows, no reconciliations have been presented.

**Notes to the IFRS reconciliation above:**

**(i) *Inclusion of coal division results***

On May 29, 2007, the Company completed the purchase of the Ivanhoe coal division (Note 21) in consideration for the issuance to Ivanhoe of 57,000,000 common shares and 25,576,383 convertible preferred shares.

*Under Canadian GAAP* – The coal transaction was accounted for as a related party transaction at the carrying value.

*Under IFRS* - The coal transaction is considered a combination between businesses or entities under common control and is therefore exempt from the scope of IFRS 3 '*Business Combinations*'. The Company has accounted for the business combinations of the entities under common control by using the principles of merger accounting as if the current group structure had always been combined.

## 3. FIRST TIME ADOPTION OF IFRS (Continued)

**Notes to the IFRS reconciliation above (continued)**

**(ii) *Fair value of embedded derivative on debt***

On April 26, 2006, in conjunction with the coal transaction, the Company entered into a line of credit facility (the "First Funding Agreement") with Ivanhoe whereby Ivanhoe agreed to make available to the Company an unsecured line of credit of up to US$10 million which was extended to a maximum of US$15 million on June 6, 2007. Attached to the First Funding Agreement was a conversion option which became effective upon the completion of the coal transaction. From April 26, 2006 to May 1, 2007 the Company accounted for any amounts drawn down on the credit facility as a liability at amortized cost and considered the fair value of the conversion feature to be insignificant because the significant milestones discussed below had not been achieved. On May 1, 2007 the conversion feature was considered to have a significant value as significant milestones surrounding the completion of the coal transaction had been achieved. These significant milestones included: (i) the signing of the definitive agreement with respect to the Company's acquisition of the coal division; (ii) approval of the coal transaction by the minority shareholders of the Company; and (iii) transfer of the coal mining licenses to the Company by Ivanhoe. From May 1, 2007 onwards the Company assigned a value of $3.1 million to the conversion feature. On January 23, 2008, concurrent with the closing of equity private placements and at the Company's request, Ivanhoe converted the then principal balance of US $29,963,354 into 14,709,701 common shares of the Company (Note 15). As a result of this conversion the amount due under the line of credit facility was eliminated.

*Under Canadian GAAP* – After the achievement of the significant milestones discussed above, the conversion feature was recorded as a separate component of equity.

*Under IFRS* – After the achievement of the significant milestones discussed above, the conversion feature is considered an embedded derivative liability that must be recorded at its fair value upon initial measurement and revalued at each subsequent reporting period. The difference between the debt host component and the principal amount of the loan outstanding is accreted to income over the remaining term of the debt.

## 3. FIRST TIME ADOPTION OF IFRS (Continued)

**Notes to the IFRS reconciliation above (continued)**

**(iii) *Adjustment on stock based compensation***

***Recognition of expense***

*Under Canadian GAAP* – Prior to 2008, the Company used the straight-line method of calculating vested options. The fair value of stock-based awards with graded vesting was calculated as one grant and the resulting fair value was recognized on a straight-line basis over the vesting period. In 2008, the Company changed from the straight-line method to the graded-vesting method.

*Under IFRS* – Each tranche of an award with different vesting dates is considered a separate grant for the calculation of fair value, and the resulting fair value is amortized over the vesting period of the respective tranches.

***Forfeitures***

*Under Canadian GAAP* – Forfeitures of awards were recognized as they occurred.

*Under IFRS* – Forfeiture estimates are recognized on the grant date and revised for actual experiences in subsequent periods.

**(iv) *Adjustment for warrant liability***

On June 28, 2005, BHP Billiton World Exploration Inc. ("BHP") purchased 1,153,998 units of the Company for $1 million. Each unit consisted of one common share and one warrant to purchase one-half a common share. The warrants had a term of two years and an exercise price of Cdn$1.395 per common share. On June 26, 2006, all outstanding warrants were exercised by BHP and the warrant liability was eliminated.

*Under Canadian GAAP* – The warrants were accounted for at carrying value as equity.

*Under IFRS* – The exercise price of the warrants is fixed in Canadian dollars. The functional currency of the Company is in U.S. dollars and therefore the conversion option is considered a derivative as the Company will receive a variable amount of cash when the warrants are exercised. As a result, the BHP warrants meet the definition of a derivative liability under IAS 39 *'Financial Instruments: Recognition and Measurement'* and is recorded as a financial liability and stated at fair value at each date of the statement of financial position.

### 3. FIRST TIME ADOPTION OF IFRS (Continued)

**Notes to the IFRS reconciliation above (continued)**

**(v) *Adjustment for asset retirement obligation ("ARO")***

At December 31, 2008 the Company did an analysis of the discount rate used to present-value its ARO liability.

*Under Canadian GAAP* – A change in the discount rate alone did not result in a re-measurement of the ARO liability.

*Under IFRS* – Under IAS 37 *'Provisions, Contingent Liabilities and Contingent Assets'* a change in the current market-based discount rate will result in a change in the measurement of the provision. As a result, the ARO liability recorded in 2008 has been re-measured using the discount rate in effect at year end and an adjustment has been recorded to the corresponding asset.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### 4.1 Basis of consolidation

The Consolidated Financial Statements include the financial statements of the Company and its controlled subsidiaries (Note 20). Control is achieved when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The results of subsidiaries acquired or disposed of during the year are included in the Consolidated Statement of Comprehensive Income from the effective date of acquisition or up to the effective date of disposal, as appropriate.

All intra-Company transactions, balances, income and expenses are eliminated in full on consolidation.

Non-controlling interests in the net assets of consolidated subsidiaries are identified separately from the Company's equity therein. Non-controlling interests consist of the amount of those interests at the date of the original business combination (see Note 4.2) and the non-controlling interests' share of changes in equity since the date of the combination. Losses applicable to the non-controlling interests in excess of their interest in the subsidiary's equity are allocated against the interests of the Company except to the extent that the non-controlling interests have a binding obligation and are able to make an additional investment to cover the losses.

### 4.2 Business combinations

Acquisitions of subsidiaries and businesses (other than entities which were under the control of the parent) are accounted for using the acquisition method. The cost of the business combination is measured as the aggregate of the fair value (at the date of exchange) of assets given, liabilities incurred or assumed, and equity instruments issued by the Company in exchange for control of the acquiree, plus any acquisition-related costs incurred to effect a business combination. The acquiree's identifiable assets, liabilities and contingent liabilities that meet the conditions for recognition under IFRS 3 '*Business Combinations*' are recognized at their fair value at the acquisition date except for non-current assets (or disposal groups) that are classified as held for sale in accordance with IFRS 5 '*Non-current Assets Held for Sale and Discontinued Operations*', which are recognized and measured at fair value less cost to sell.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.2 Business combinations (continued)

A business combination involving businesses under common control is a business combination in which all of the combining businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory. Business combinations under common control are accounted for in accordance with the principle of merger accounting. In applying the principle of merger accounting, the Consolidated Financial Statements incorporate the financial statement items of the combining businesses in which the common control combination occurs as if they had been combined from the date when the combining business first came under the control of the controlling party.

The net assets of the combining businesses are combined using the existing book values prior to the common control combinations from the controlling parties' perspective. No amount is recognized in respect of goodwill or excess of acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost at the time of common control combination, to the extent of the continuation of the controlling party's interest.

The Consolidated Statement of Comprehensive Income includes the results of each of the combining businesses from the earliest date presented or since the date when the combining businesses first came under the common control, where this is a shorter period, regardless of the date of common control combination.

### 4.3 Interest income

Interest income from financial assets is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.4 Foreign currencies

The Company's reporting currency and the functional currency of all of its operations is the U.S. dollar as this is the principal currency of the economic environment in which they operate.

Transactions in foreign currencies are initially recorded at the functional currency rate at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the date of the statement of financial position.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value is determined.

### 4.5 Borrowing costs

Borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset are capitalized as part of the cost of that asset. Other borrowing costs not directly attributable to a qualifying asset are expensed in the period incurred.

### 4.6 Inventories

Coal inventories are stated at lower of production cost and net realizable value. Production costs include direct and indirect labour, operating materials and supplies, transportation costs and an appropriate portion of fixed and variable overhead expenses, including depreciation and depletion. Net realizable value represents the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

Supplies inventory consists of consumable parts and supplies which are valued at lower of average cost and net realizable value. Supplies used in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. Net realizable value is defined as the selling price of the finished product less any provisions for obsolescence and costs of completion.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.7 Property, plant and equipment ("PPE")

Property, plant and equipment are stated at cost less accumulated depreciation and accumulated impairment losses. The cost of an item of PPE consists of the purchase price, any costs directly attributable to bringing the asset to the location and condition necessary for its intended use and an initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

Depreciation is provided at rates calculated to write off the cost of PPE, less their estimated residual value, using the straight line method or unit-of-production method over the following expected useful lives:

- Mobile equipment — 5 years
- Computer equipment — 1 to 5 years
- Furniture and fixtures — 5 years
- Machinery and equipment — 3 to 10 years
- Buildings and roads — 5 to 15 years
- Construction in progress — see below
- Mineral assets — based on resources on a unit-of-production basis

Construction in progress includes PPE in the course of construction for production or for its own use purposes. Construction in progress is carried at cost less any recognized impairment loss. Construction in progress is classified to the appropriate category of PPE when completed and ready for intended use. Depreciation of these assets, on the same basis as other property assets, commences when the assets are ready for their intended use.

Mineral assets include deferred stripping costs and asset retirement obligations related to the reclamation of mining.

An item of PPE is derecognized upon disposal, when held for sale or when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss arising on disposal of the asset, determined as the difference between the net disposal proceeds and the carrying amount of the asset, is recognized in the Consolidated Statement of Comprehensive Income.

The Company conducts an annual assessment of the residual balances, useful lives and depreciation methods being used for PPE and any changes arising from the assessment are applied by the Company prospectively.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.8 Stripping costs

Stripping costs incurred during the development of a mine are capitalized into PPE. Stripping costs incurred during the production phase are variable production costs that are included in the costs of inventory produced during the period that the stripping costs are incurred, unless the stripping activity can be shown to give rise to future benefits from the mineral property, in which case the stripping costs would be capitalized into PPE. Future benefits arise when stripping activity increases the future output of the mine by providing access to a new ore body. Capitalized stripping costs are depleted on a unit-of production basis, using estimated resources as the depletion base.

### 4.9 Mineral properties

All direct costs related to the acquisition of mineral property interests are capitalized into intangible assets on a property by property basis. Exploration costs, net of incidental revenues, are charged to operations in the period incurred until such time as it has been determined that a property has economically recoverable reserves, in which case subsequent exploration costs and the costs incurred to develop a property are capitalized into PPE. Exploration costs include value-added taxes incurred in foreign jurisdictions when recoverability of these taxes is uncertain. On the commencement of commercial production, depletion of each mining property will be provided on a unit-of-production basis using estimated resources as the depletion base.

Certain of the Company's exploration and development activities are conducted jointly with others. These Consolidated Financial Statements reflect only the Company's interests in such activities.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.10 Decommissioning, restoration and similar liabilities ("Asset retirement obligation" or "ARO")

The Company recognizes liabilities for statutory, contractual, constructive or legal obligations, including those associated with the reclamation of mineral properties and PPE, when those obligations result from the acquisition, construction, development or normal operation of the assets. Initially, a liability for an asset retirement obligation is recognized as its fair value in the period in which it is incurred. Upon initial recognition of the liability, the corresponding asset retirement obligation is added to the carrying amount of the related asset and the cost is amortized as an expense over the economic life of the asset using either the unit-of-production method or the straight-line method, as appropriate. Following the initial recognition of the asset retirement obligation, the carrying amount of the liability is increased for the passage of time and adjusted for changes to the current market-based discount rate, amount or timing of the underlying cash flows needed to settle the obligation.

### 4.11 Share-based payments

***Share-based payment transactions***

Employees (including directors and senior executives) of the Company receive a portion of their remuneration in the form of share-based payment transactions, whereby employees render services as consideration for equity instruments ("equity-settled transactions").

In situations where equity instruments are issued and some or all of the goods or services received by the entity as consideration cannot be specifically identified, they are measured at fair value of the share-based payment.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.11 Share-based payments (continued)

***Equity-settled transactions***

The costs of equity-settled transactions with employees are measured by reference to the fair value at the date on which they are granted.

The costs of equity-settled transactions are recognized, together with a corresponding increase in equity, over the period in which the performance and/or service conditions are fulfilled, ending on the date on which the relevant employees become fully entitled to the award ("the vesting date"). The cumulative expense is recognized for equity-settled transactions at each reporting date until the vesting date reflects the Company's best estimate of the number of equity instruments that will ultimately vest. The profit or loss charge or credit for a period represents the movement in cumulative expense recognized as at the beginning and end of that period and the corresponding amount is represented in share option reserve.

No expense is recognized for awards that do not ultimately vest, except for awards where vesting is conditional upon a market condition, which are treated as vesting irrespective of whether or not the market condition is satisfied provided that all other performance and/or service conditions are satisfied.

Where the terms of an equity-settled award are modified, the minimum expense recognized is the expense as if the terms had not been modified. An additional expense is recognized for any modification which increases the total fair value of the share-based payment arrangement, or is otherwise beneficial to the employee as measured at the date of modification.

The dilutive effect of outstanding options is reflected as additional dilution in the computation of earnings per share.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.12 Taxation

Income tax expense represents the sum of tax currently payable and deferred tax.

***Current income tax***

Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted by the date of the statement of financial position.

***Deferred income tax***

Deferred income tax is provided using the liability method on temporary differences at the date of the statement of financial position between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities are recognized for all taxable temporary differences, except:

- where the deferred income tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.12 Taxation (continued)

Deferred income tax assets are recognized for all deductible temporary differences, carry forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and the carry forward of unused tax credits and unused tax losses can be utilized except:

- where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of deductible temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, deferred income tax assets are recognized only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary differences can be utilized.

The carrying amount of deferred income tax assets is reviewed at each date of the statement of financial position and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilized. Unrecognized deferred income tax assets are reassessed at each date of the statement of financial position and are recognized to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply to the year when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the date of the statement of financial position.

Deferred income tax relating to items recognized directly in equity is recognized in equity and not in the statement of comprehensive income.

Deferred income tax assets and deferred income tax liabilities are offset if, and only if, a legally enforceable right exists to set off current tax assets against current tax liabilities and the deferred tax assets and liabilities relate to income taxes levied by the same taxation authority on either the same taxable entity or different taxable entities which intend to either settle current tax liabilities and assets on a net basis, or to realize the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax assets or liabilities are expected to be settled or recovered.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.13 Loss per share

The basic loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding during the period. The diluted loss per share reflects the potential dilution of common share equivalents, such as outstanding stock options and share purchase warrants, in the weighted average number of common shares outstanding during the year, if dilutive. The "treasury stock method" is used for the assumed proceeds upon the exercise of the options and warrants that are used to purchase common shares at the average market price during the year. During the six months ended June 30, 2009 and 2008 all the outstanding stock options and warrants were anti-dilutive.

### 4.14 Financial assets

All financial assets are initially recorded at fair value and designated upon inception into one of the following four categories: held-to-maturity, available-for-sale, loans-and-receivables or at fair value through profit or loss ("FVTPL").

Financial assets classified as FVTPL are measured at fair value with unrealized gains and losses recognized through earnings. The Company's cash and short-term money market investments are classified as FVTPL.

Financial assets classified as loans-and-receivables and held-to-maturity are measured at amortized cost. The Company's trade and other receivables are classified as loans-and-receivables.

Financial assets classified as available-for-sale are measured at fair value with unrealized gains and losses recognized in other comprehensive income (loss) except for losses in value that are considered other than temporary. At June 30, 2009 the Company has not classified any financial assets as available-for-sale.

Transactions costs associated with FVTPL financial assets are expensed as incurred, while transaction costs associated with all other financial assets are included in the initial carrying amount of the asset.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.15 Financial liabilities

All financial liabilities are initially recorded at fair value and designated upon inception as FVTPL or other-financial-liabilities.

Financial liabilities classified as other-financial-liabilities are initially recognized at fair value less directly attributable transaction costs. After initial recognition, other-financial-liabilities are subsequently measured at amortized cost using the effective interest method. The effective interest method is a method of calculating the amortized cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments through the expected life of the financial liability, or, where appropriate, a shorter period. The Company's trade and other payables, deposits received and amounts due under line of credit facilities are classified as other-financial-liabilities.

Financial liabilities classified as FVTPL include financial liabilities held for trading and financial liabilities designated upon initial recognition as FVTPL. Derivatives, including separated embedded derivatives are also classified as held for trading unless they are designated as effective hedging instruments. Fair value changes on financial liabilities classified as FVTPL are recognized through the statement of comprehensive income. At June 30, 2009 the Company has not classified any financial liabilities as FVTPL.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.16 Impairment of financial assets

The Company assesses at each date of the statement of financial position whether a financial asset is impaired.

***Assets carried at amortized cost***

If there is objective evidence that an impairment loss on assets carried at amortized cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The carrying amount of the asset is then reduced by the amount of the impairment. The amount of the loss is recognized in profit or loss.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed to the extent that the carrying value of the asset does not exceed what the amortized cost would have been had the impairment not been recognized. Any subsequent reversal of an impairment loss is recognized in profit or loss.

In relation to trade receivables, a provision for impairment is made and an impairment loss is recognized in profit and loss when there is objective evidence (such as the probability of insolvency or significant financial difficulties of the debtor) that the Company will not be able to collect all of the amounts due under the original terms of the invoice. The carrying amount of the receivable is reduced through use of an allowance account. Impaired debts are written off against the allowance account when they are assessed as uncollectible.

***Available-for-sale***

If an available-for-sale asset is impaired, an amount comprising the difference between its cost and its current fair value, less any impairment loss previously recognized in profit or loss, is transferred from equity to profit or loss. Reversals in respect of equity instruments classified as available-for-sale are not recognized in profit or loss.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.17 Impairment of non-financial assets

At each date of the statement of financial position, the Company reviews the carrying amounts of its tangible and intangible assets to determine whether there is an indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). Where it is not possible to estimate the recoverable amount of an individual asset, the Company estimates the recoverable amount of the cash-generating unit to which the assets belong.

Recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (or cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognized immediately in the statement of comprehensive income, unless the relevant asset is carried at a revalued amount, in which case the impairment loss is treated as a revaluation decrease.

Where an impairment loss subsequently reverses, the carrying amount of the asset (cash-generating unit) is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset (or cash-generating unit) in prior years.

### 4.18 Cash and cash equivalents

Cash and cash equivalents in the statement of financial position comprise cash at banks and on hand, and short term deposits with an original maturity of three months or less, which are readily convertible into a known amount of cash.

### 4.19 Revenue recognition

Sales revenues are recognized when the risks and rewards of ownership pass to the buyer, collection is reasonably assured and the price is reasonably determinable. This occurs when coal is either loaded onto a truck or when it is unloaded at the final destination, depending on the terms of the contract.

## 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### 4.20 Provisions

Provisions are recognized when the Company has a present obligation (legal or constructive) that has arisen as a result of a past event and it is probable that a future outflow of resources will be required to settle the obligation, provided that a reliable estimate can be made of the amount of the obligation.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risk specific to the obligation. The increase in the provision due to passage of time is recognized as interest expense.

### 4.21 Related party transactions

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence, related parties may be individuals or corporate entities. A transaction is considered to be a related party transaction when there is a transfer of resources or obligations between related parties. Related party transactions that are in the normal course of business and have commercial substance are measured at the exchange amount.

### 4.22 Significant accounting judgments and estimates

The preparation of these financial statements requires management to make judgements and estimates and form assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. On an ongoing basis, management evaluates its judgements and estimates in relation to assets, liabilities, revenue and expenses. Management uses historical experience and various other factors it believes to be reasonable under the given circumstances as the basis for its judgements and estimates. Actual outcomes may differ from these estimates under different assumptions and conditions. The most significant estimates relate to asset retirement obligations; capital assets, including coal reserves and resources, depreciation and depletion; recoverability of accounts receivable, inventory valuation; valuation of deferred income tax amounts, impairment testing and the calculation of share-based payments. The most significant judgements relate to recoverability of capitalized amounts, recognition of deferred tax assets and liabilities, determination of the commencement of commercial production and the determination of the economic viability of a project.

## 5. SEGMENTED INFORMATION

At June 30, 2009, the Company has two reportable operating segments, being the Mongolian Coal Division and Indonesian Coal Division. In prior periods, the Company's Metals Division was a segment of the Company (Note 6).

An operating segment is defined as a component of the Company:

- that engages in business activities from which it may earn revenues and incur expenses;
- whose operating results are reviewed regularly by the entity's chief operating decision maker; and
- for which discrete financial information is available.

For both the Mongolian Coal Division and Indonesian Coal Division, the Company receives discrete financial information that is used by the chief operating decision maker to make decisions about resources to be allocated to the segment and to assess its performance. Both divisions are principally engaged in the acquisition, exploration and development of coal properties in distinct geographical locations. As at June 30, 2009, the Mongolian Coal Division has achieved commercial production and is earning revenue through the sale of coal to external customers. As at June 30, 2009, the Indonesian Coal Division has yet to achieve commercial production and therefore has no revenues and is still in the exploration and development stage.

The Company's Corporate Division only earns revenues that are considered incidental to the activities of the Company and therefore does not meet the definition of an operating segment as defined in IFRS 8 *'Operating Segments'*.

At June 30, 2009 the Mongolian Coal Division had two active customers with the largest customer accounting for 62% of trade receivables and the other customer accounting for 38% of trade receivables. For the six months ended June 30, 2009 the largest customer accounted for 61% of revenues and the other customer accounted for 39% of revenues.

## 5. SEGMENTED INFORMATION (Continued)

The following is an analysis of the carrying amounts of segment assets, segment liabilities and reported segment profit or loss, revenues and depreciation expense analyzed by operating segment and reconciled to the Company's Consolidated Financial Statements:

| | Mongolian Coal Division | Indonesian Coal Division | Metals Division (i) | Unallocated (ii) | Consolidated Total |
|---|---|---|---|---|---|
| **Segment assets** | | | | | |
| As at June 30, 2009 | $ 92,526,976 | $ 20,136,319 | $ - | $ 1,369,674 | $ 114,032,969 |
| As at December 31, 2008 | 76,611,232 | 14,835,690 | 637,600 | 7,863,487 | 99,948,009 |
| As at December 31, 2007 | 2,509,471 | - | 1,132,269 | 1,968,337 | 5,610,077 |
| **Segment liabilities** | | | | | |
| As at June 30, 2009 | $ 3,724,025 | $ 1,884,127 | $ - | $ 27,215,632 | $ 32,823,784 |
| As at December 31, 2008 | 3,101,017 | 810,929 | 255,080 | 6,816,292 | 10,983,318 |
| As at December 31, 2007 | 835,998 | - | 269,795 | 106,335,371 | 107,441,164 |
| **Segment losses** | | | | | |
| For 3 months ended June 30, 2009 | $ 462,394 | $ 2,771,973 | $ - | $ 4,675,833 | $ 7,910,200 |
| For 3 months ended June 30, 2008 | 9,130,168 | 1,232,966 | 2,392,568 | 825,556 | 13,581,258 |
| For 6 months ended June 30, 2009 | 1,972,176 | 6,115,497 | - | 9,782,817 | 17,870,490 |
| For 6 months ended June 30, 2008 | 13,022,363 | 3,715,278 | 3,695,230 | 9,359,738 | 29,792,609 |
| **Segment revenues** | | | | | |
| For 3 months ended June 30, 2009 | $ 10,666,362 | $ - | $ - | $ - | $ 10,666,362 |
| For 3 months ended June 30, 2008 | - | - | - | - | - |
| For 6 months ended June 30, 2009 | 14,206,958 | - | - | - | $ 14,206,958 |
| For 6 months ended June 30, 2008 | - | - | - | - | - |
| **Depreciation and depletion expense** | | | | | |
| For 3 months ended June 30, 2009 | $ 1,622,831 | $ - | $ - | $ 3,392 | $ 1,626,223 |
| For 3 months ended June 30, 2008 | 20,144 | - | 14,132 | 34,351 | 68,627 |
| For 6 months ended June 30, 2009 | 2,040,522 | - | - | 7,016 | 2,047,538 |
| For 6 months ended June 30, 2008 | 63,458 | - | 31,202 | 70,249 | 164,909 |

(i) The Metals Division was disposed of effective December 30, 2008 (Note 6)
(ii) The unallocated amount contains all amounts associated with the Corporate Division

## 5. SEGMENTED INFORMATION (Continued)

The Company operates in four geographical areas, being Canada, Hong Kong, Indonesia and Mongolia. The following is an analysis of the revenues and non-current assets by geographical area and reconciled to the Company's Consolidated Financial Statements:

| | Mongolia | Indonesia | Hong Kong | Canada | Consolidated Total |
|---|---|---|---|---|---|
| **Revenues** | | | | | |
| For 3 months ended June 30, 2009 | $ 10,666,362 | $ - | $ - | $ - | $ 10,666,362 |
| For 3 months ended June 30, 2008 | - | - | - | - | - |
| For 6 months ended June 30, 2009 | 14,206,958 | - | - | - | 14,206,958 |
| For 6 months ended June 30, 2008 | - | - | - | - | - |
| **Non-current assets** | | | | | |
| As at June 30, 2009 | $ 60,729,114 | $ 17,644,271 | $ 53,217 | $ 72,263 | $ 78,498,865 |
| As at December 31, 2008 | 51,938,584 | 13,688,975 | - | 20,570 | 65,648,129 |
| As at December 31, 2007 | 1,398,348 | 62,175 | - | 106,217 | 1,566,740 |

## 6. DISCONTINUED OPERATIONS

The Company sold the Metals Division, effective December 30, 2008 with a closing date of February 2, 2009 to Ivanhoe for $3 million. In addition, Ivanhoe provided the Company with a $30 million credit facility for a one year period (Note 15). Ivanhoe has provided the Company with the economic equivalent of a 1% Net Smelter Royalty on the Sulawesi and Kerta Projects in Indonesia. The Metals Division consisted of certain base and precious metals properties in Mongolia and Indonesia. The Company received the proceeds of $3 million in December 2008 and this receipt was reflected in the 2008 Consolidated Statement of Financial Position and Consolidated Statement of Cash Flows. The Company has recorded a gain of $2,617,480 in the six months ended June 30, 2009 on the sale of the Metals Division and this gain has been recorded directly into equity as the sale of the division was to the parent of the Company.

The Metals Division was presented as a discontinued operation and financial results were presented as separate items in the Consolidated Statement of Comprehensive Income, and Consolidated Statement of Cash Flows. The Metals Division assets and liabilities consolidated by the Company in 2008 were segregated in the Consolidated Statement of Financial Position and classified as assets and liabilities held for sale.

The loss from discontinued operations for the six months ended June 30, 2009 and 2008 is as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Evaluation and exploration expenses | **$ -** | $ 2,392,568 | **$ -** | $ 3,695,230 |
| Net loss from discontinued operations | **$ -** | $ 2,392,568 | **$ -** | $ 3,695,230 |
| Basic and diluted loss per share from discontinued operations | **$ -** | $ 0.02 | **$ -** | $ 0.03 |

### 6. DISCONTINUED OPERATIONS (Continued)

The carrying values of net assets related to the discontinued operations are as follows:

| | As at June 30, | As at December 31, | |
|---|---|---|---|
| | **2009** | 2008 | 2007 |
| **Assets** | | | |
| **Current assets** | | | |
| Cash and cash equivalents | $ - | $ 222,699 | $ - |
| Trade and other receivables | - | 184,022 | - |
| Prepaid expenses and deposits | - | 133,664 | - |
| Property, plant and equipment | - | 97,215 | - |
| **Total current assets** | - | 637,600 | - |
| **Total assets** | $ - | $ 637,600 | $ - |
| **Current liabilities** | | | |
| Trade and other payables | $ - | $ 255,080 | $ - |
| **Net assets of discontinued operations** | $ - | $ 382,520 | $ - |

### 7. COST OF SALES

The cost of sales of the Company is broken down into its cash and non-cash components as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Operating expenses (i) | $ 7,526,289 | $ - | $ 10,321,913 | $ - |
| Depreciation and depletion | 1,612,397 | - | 2,030,088 | - |
| **Cost of sales** | $ 9,138,686 | $ - | $ 12,352,001 | $ - |

(i) Share-based compensation (a non-cash item) of $558,468 (2008 - $nil) and $995,659 (2008 - $nil) has been included in Operating expenses for the three months and six months ended June 30, 2009, respectively.

## 8. ADMINISTRATION EXPENSES

The administration expenses for the Company are broken down as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Corporate administration | **$ 465,832** | $ 570,354 | **$ 1,046,471** | $ 900,231 |
| Legal | **64,220** | 63,852 | **204,395** | 264,882 |
| Professional fees | **561,213** | 98,828 | **1,147,785** | 223,764 |
| Listing fees | **97,390** | - | **332,545** | - |
| Salaries and benefits (i) | **3,103,931** | 1,372,287 | **6,819,595** | 2,248,504 |
| Depreciation and depletion | **3,392** | 34,351 | **7,016** | 70,249 |
| Foreign exchange loss/(gain) | **148,582** | (734,061) | **991,726** | (1,195,573) |
| **Administration expenses** | **$ 4,444,560** | $ 1,405,611 | **$10,549,533** | $ 2,512,057 |

(i) Share-based compensation (a non-cash item) of $2,553,426 (2008 - $687,982) and $5,847,132 (2008 - $1,271,189) has been included in Salaries and benefits for the three months and six months ended June 30, 2009, respectively.

## 9. EVALUATION AND EXPLORATION EXPENSES

The evaluation and exploration expenses for the Company are broken down as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Mongolian Coal Division (i) | **$ 1,742,433** | $ 9,130,168 | **$ 2,510,651** | $ 13,022,363 |
| Indonesian Coal Division (ii) | **2,898,083** | 1,232,966 | **6,260,016** | 3,715,278 |
| **Evaluation and exploration expenses** | **$ 4,640,516** | $ 10,363,134 | **$ 8,770,667** | $ 16,737,641 |

(i) Share-based compensation (a non-cash item) of $76,254 (2008 - $430,158) and $77,530 (2008 - $749,095) has been included in Evaluation and exploration expenses for the Mongolian Coal Division for the three months and six months ended June 30, 2009, respectively.
(ii) Share-based compensation (a non-cash item) of $82,553 (2008 - $nil) and $197,448 (2008 - $nil) has been included in Evaluation and exploration expenses for the Indonesian Coal Division for the three months and six months ended June 30, 2009, respectively.

## 10. FINANCE COSTS

The finance costs for the Company are broken down as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Fair value change on embedded derivative (Note 15.4) | **$ -** | $ - | **$ -** | $ 7,223,399 |
| Interest accretion on line of credit facility | **-** | - | **-** | 598,408 |
| Interest expense (Note 15.3) | **344,955** | - | **397,695** | 134,186 |
| Accretion on asset retirement obligation | **10,767** | - | **19,926** | - |
| **Finance costs** | **$ 355,722** | $ - | **$ 417,621** | $ 7,955,993 |

## 11. LOSS PER SHARE

The calculation of basic and diluted loss per share for the relevant periods is based on the following data:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Net loss from continuing and discontinued operations for the purpose of basic and diluted loss per share | **$ 7,910,200** | $ 13,581,258 | **$ 17,870,490** | $ 29,792,609 |
| Weighted average number of shares for the purpose of basic and diluted loss per share | **133,352,408** | 131,488,263 | **133,307,891** | 130,867,406 |

All of the outstanding preference shares, stock options and warrants were anti-dilutive for the relevant periods.

## 12. INVENTORIES

The inventories for the Company are categorized as follows:

| | As at June 30, | As at December 31, | |
|---|---|---|---|
| | **2009** | **2008** | **2007** |
| Stockpiles [(i)] | **$ 10,791,423** | $ 13,158,009 | $ - |
| Materials and supplies | **654,429** | 518,707 | - |
| **Total inventories** | **$ 11,445,852** | $ 13,676,716 | $ - |

(i) Coal inventories are stated at production cost

The amount of inventories recognized as an expense during the six months ended June 30, 2009 is $7,245,711 (2008 - $nil). As at June 30, 2009 the Company anticipates the entire stockpiles balance of $10,791,423 will be realized within a year.

## 13. INTANGIBLE ASSETS

The Company's intangible assets are broken down as follows:

| | Mineral properties - Indonesian Coal Division | Mineral properties - Metals Division | Total |
|---|---|---|---|
| Balance, As at January 1, 2007 | $ - | $ 443,360 | $ 443,360 |
| Additions | - | - | - |
| Depletion | - | - | - |
| Balance, As at December 31, 2007 | - | 443,360 | 443,360 |
| Additions | 13,208,218 | - | 13,208,218 |
| Depletion | - | - | - |
| Dispositions | - | (443,360) | (443,360) |
| Balance, As at December 31, 2008 | 13,208,218 | - | 13,208,218 |
| Additions | - | - | - |
| Depletion | - | - | - |
| **Balance, As at June 30, 2009** | **$ 13,208,218** | **$ -** | **$ 13,208,218** |

## 13. INTANGIBLE ASSETS (Continued)

### 13.1 Indonesian Coal Division

The Company holds an interest in the Mamahak Coal Project in East Kalimantan, Indonesia. The Joint Venture Earn-in Agreement with Score Resources Ltd ("Score") included a provision allowing for the Company to increase its working interest position based on a predetermined pricing mechanism. In 2008, the Company elected to increase its working interest from 56% to 85% by paying Score $13.2 million, comprised of $8,013,800 cash and 320,000 common shares of the Company at Canadian dollar $16.15 per share as specified in the agreement with Score.

## 14. PROPERTY, PLANT AND EQUIPMENT

The Property, plant and equipment for the Company is broken down as follows:

| | Mobile equipment | Computer equipment | Furniture and fixtures | Machinery and equipment | Buildings and roads | Mineral assets | Construction in progress | Total |
|---|---|---|---|---|---|---|---|---|
| **Cost** | | | | | | | | |
| As at January 1, 2007 | $ 202,680 | $ 195,274 | $ 61,832 | $ 108,407 | $ - | $ - | $ 150,000 | $ 718,193 |
| Additions | 91,611 | 169,138 | 81,070 | 155,422 | - | - | 234,635 | 731,876 |
| Disposals | (43,483) | - | (14,063) | - | - | - | - | (57,546) |
| As at December 31, 2007 | 250,808 | 364,412 | 128,839 | 263,829 | - | - | 384,635 | 1,392,523 |
| Additions | 38,283,037 | 272,147 | 31,934 | 1,907,359 | 432,491 | 3,421,803 | 11,026,184 | 55,374,955 |
| Disposals | (49,539) | (119,584) | (68,490) | (19,921) | - | - | - | (257,534) |
| As at December 31, 2008 | 38,484,306 | 516,975 | 92,283 | 2,151,267 | 432,491 | 3,421,803 | 11,410,819 | 56,509,944 |
| Additions | 10,165,496 | 43,742 | 254,932 | - | 881,110 | 1,790,722 | 2,518,214 | 15,654,216 |
| Disposals | (462,994) | (33,304) | (6,530) | - | - | - | (6,565) | (509,393) |
| Reclassification | - | - | - | 93,701 | 2,472,462 | - | (2,566,163) | - |
| As at June 30, 2009 | $ 48,186,808 | $ 527,413 | $ 340,685 | $ 2,244,968 | $ 3,786,063 | $ 5,212,525 | $ 11,356,305 | $ 71,654,767 |
| **Accumulated depreciation** | | | | | | | | |
| As at January 1, 2007 | $ (59,779) | $ (95,022) | $ (11,052) | $ (57,067) | $ - | $ - | $ - | $ (222,920) |
| Charge for the year | (9,149) | (32,736) | (3,348) | (2,395) | - | - | - | (47,628) |
| Eliminated on disposals | - | - | 1,405 | - | - | - | - | 1,405 |
| As at December 31, 2007 | (68,928) | (127,758) | (12,995) | (59,462) | - | - | - | (269,143) |
| Charge for the year | (3,465,315) | (204,031) | (23,228) | (68,787) | (76,744) | (84,937) | - | (3,923,042) |
| Eliminated on disposals | 11,122 | 84,148 | 17,452 | 9,430 | - | - | - | 122,152 |
| As at December 31, 2008 | (3,523,121) | (247,641) | (18,771) | (118,819) | (76,744) | (84,937) | - | (4,070,033) |
| Charge for the period | (2,372,995) | (35,064) | (13,051) | (170,378) | (116,502) | (11,062) | - | (2,719,052) |
| Eliminated on disposals | 334,207 | 32,927 | 3,664 | - | - | - | - | 370,798 |
| As at June 30, 2009 | $ (5,561,909) | $ (249,778) | $ (28,158) | $ (289,197) | $ (193,246) | $ (95,999) | $ - | $ (6,418,287) |
| **Net book value** | | | | | | | | |
| As at December 31, 2007 | 181,880 | 236,654 | 115,844 | 204,367 | - | - | 384,635 | 1,123,380 |
| As at December 31, 2008 | 34,961,185 | 269,334 | 73,512 | 2,032,448 | 355,747 | 3,336,866 | 11,410,819 | 52,439,911 |
| As at June 30, 2009 | $ 42,624,899 | $ 277,635 | $ 312,527 | $ 1,955,771 | $ 3,592,817 | $ 5,116,526 | $ 11,356,305 | $ 65,236,480 |

## 15. AMOUNTS DUE UNDER LINE OF CREDIT FACILITIES

### 15.1 First funding agreement

In April 2006, the Company entered into a line of credit facility (the "First Funding Agreement") with Ivanhoe, whereby Ivanhoe agreed to make available to the Company an unsecured line of credit facility of up to $10 million which was extended to a maximum of $15 million, excluding interest and the interim coal expenditures. All amounts outstanding under the line of credit bore interest at the three month London Interbank Offered Rate ("LIBOR") plus 200 basis points. In May 2007, the Company completed the purchase of the Ivanhoe coal division (Note 21) in consideration for the issuance to Ivanhoe of 57,000,000 common shares and 25,576,383 preferred shares of the Company. The First Funding Agreement became convertible into common shares at the election of either the Company or Ivanhoe. Until May 29, 2008, the Company had the right to require Ivanhoe to convert the outstanding amounts under the First Funding Agreement into common shares at a conversion price of Canadian dollar ("Cdn$") $2.09 per share. Until August 29, 2008, Ivanhoe had the right to convert the outstanding amounts under the First Funding Agreement into common shares at a conversion price of Cdn$2.35 per share.

On January 23, 2008, Ivanhoe converted 25,576,383 preferred shares, the total sum of preferred shares held by Ivanhoe, into common shares of the Company on a one-for-one basis. At the Company's request, Ivanhoe also converted $29,982,631 of debt into 14,709,071 common shares of the Company. As a result of this conversion, the amounts due under the line of credit facility owed to Ivanhoe on the First Funding Agreement were eliminated. Under IAS 32 *'Financial Instruments: Presentation'* the conversion feature was considered an embedded derivative and this feature has been discussed further in Note 15.4.

### 15.2 Second funding agreement

In October 2007, Ivanhoe and the Company entered into a second interim funding agreement (the "Second Funding Agreement"). The Second Funding Agreement provided for an additional unsecured non-convertible line of credit facility of up to $32.5 million. All amounts outstanding under the line of credit bore interest at LIBOR plus 330 basis points.

On January 18, 2008, funds in the amount of $8,077,470 were paid to Ivanhoe representing repayment in full of the principal of $8.0 million and accrued interest of $77,470 owing on the Second Funding Agreement. The Second Funding Agreement was then terminated.

## 15. AMOUNTS DUE UNDER LINE OF CREDIT FACILITIES (Continued)

### 15.3 Credit facility

On December 30, 2008, the Company established a credit facility with Ivanhoe which allows the Company to obtain advances from Ivanhoe to an aggregate maximum of $30 million, the amount was subsequently extended to an aggregate maximum of $60 million (Note 24). The credit facility is unsecured non-convertible and carries an interest rate equal to LIBOR plus 750 basis points. The effective interest rate at June 30, 2009 was 8.095%. At June 30, 2009, the Company had received advances of $24 million against the credit facility and has accrued interest expense of $397,695 for the six months ended June 30, 2009 ($344,955 for the three months ended June 30, 2009).

### 15.4 Embedded derivative

The Company accounted for any amounts drawn on the First Funding Agreement (Note 15.1) from April 26, 2006 to May 1, 2007 as a liability recorded at amortized cost. On May 29, 2007, the entire indebtedness became convertible into ordinary shares of the Company at the election of either Ivanhoe or the Company. Until May 29, 2008, the Company had the right to require Ivanhoe to convert the outstanding loan into common shares at a conversion price of Cdn$2.09 per share. Until August 29, 2008, Ivanhoe had the right to convert the outstanding loan into common shares at a conversion price of Cdn$2.35 per share.

On January 23, 2008 at the Company's request, Ivanhoe converted $29,982,631 of debt into 14,709,071 common shares of the Company. As a result of this conversion the amount due under the convertible line of credit facility was eliminated.

At the date of conversion the fair value of the embedded derivative and the debt outstanding was $107,551,903 which was converted and recorded as common share capital. All preferred shares were also converted to common shares on that date.

The Company identified that the conversion feature was an embedded derivative to be presented as a liability in accordance with IAS 32 *'Financial Instruments: Presentation'* due to the variable number of shares that would be issued on conversion. This resulted from the debt being denominated in U.S. dollar but being convertible at a fixed conversion rate into Canadian dollar denominated shares.

## 15. AMOUNTS DUE UNDER LINE OF CREDIT FACILITIES (Continued)

### 15.4 Embedded derivative (continued)

The debt that was recorded prior to May 1, 2007 was recorded at face value as a liability at amortized cost. On May 1, 2007 the conversion feature was considered to have a value and was recorded at fair value in addition to the value of the previously recorded debt. All subsequent advances on the line of credit were valued at fair value and the value of the debt host was deemed to be nil on account of the beneficial feature which exceeded the fair value of the debt. The difference between the host debt component of $nil and the principal amount of the loan outstanding was accreted to income over the remaining term of the debt. At each reporting period the embedded derivative was fair valued, with the movements recorded in income.

The embedded derivative was valued upon initial measurement and at each drawing date using the Black-Scholes option valuation model. The following variables were used to calculate the impact of the call and put option elements of the embedded derivative. Some amounts below have been stated in Cdn$, all other amounts are in U.S. dollar.

| | Drawn down date | | | | | Cumulative at | |
|---|---|---|---|---|---|---|---|
| | May 10, 2007 | May 29, 2007 | July 4, 2007 | August 21, 2007 | October 1, 2007 | December 31, 2007 | January 23, 2008 |
| Principal and interest borrowed | $ 1,000,000 | $ 13,212,395 | $ 2,000,000 | $ 2,500,000 | $ 2,000,000 | $ 29,855,178 | $ 29,963,354 |
| Stock price | Cdn$4.81 | Cdn$5.00 | Cdn$8.00 | Cdn$6.20 | Cdn$6.68 | Cdn$8.90 | Cdn$9.45 |
| Dividend yield | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| *Call option* | | | | | | | |
| Interest rate | 4.60% | 4.60% | 4.68% | 4.05% | 4.21% | 3.93% | 3.41% |
| Volatility | 76.19% | 76.19% | 77.15% | 76.62% | 70.49% | 58.66% | 59.89% |
| Exercise price | Cdn$2.35 | Cdn$2.35 | Cdn$2.35 | Cdn$2.35 | Cdn$2.35 | Cdn$2.35 | Cdn$2.35 |
| Expected life (years) | 0.91 | 0.91 | 1.16 | 1.02 | 0.91 | 0.66 | 0.60 |
| *Put option* | | | | | | | |
| Interest rate | 4.61% | 4.61% | 4.68% | 4.05% | 4.21% | 3.91% | 3.41% |
| Volatility | 76.19% | 76.19% | 77.15% | 75.09% | 75.76% | 50.58% | 55.06% |
| Exercise price | Cdn$2.09 | Cdn$2.09 | Cdn$2.09 | Cdn$2.09 | Cdn$2.09 | Cdn$2.09 | Cdn$2.09 |
| Expected life (years) | 0.91 | 0.91 | 0.81 | 0.77 | 0.66 | 0.41 | 0.35 |
| **Net embedded derivative** | $ 1,185,033 | $ 15,657,121 | $ 4,893,436 | $ 4,279,665 | $ 3,787,946 | $ 83,998,434 | $ 91,221,833 |

As at December 31, 2007, $63,266,762 had been recorded as a charge against income within finance costs relating to the movement in fair value of the embedded derivative. At the elimination of the debt on January 23, 2008, the fair value of the embedded derivative was $91,202,557 and $7,223,399 had been recorded as a charge against income within finance costs in the three month period ended March 31, 2008. The debt cost was recorded at fair value, with the difference between the cost and the principal amount being accreted as interest charges over the term of the debt. The total accretion expense recorded as interest cost to January 23, 2008 was $6,480,703.

## 16. ASSET RETIREMENT OBLIGATION

Reclamation and closure costs have been estimated based on the Company's interpretation of current regulatory requirements and have been measured at fair value. Fair value is determined based on the net present value of future cash expenditures upon reclamation and closure. Reclamation and closure costs are capitalized into PPE dependant on the nature of the asset related to the obligation and amortized over the life of the related asset.

The asset retirement obligations relate to reclamation and closure costs of the Company's Ovoot Tolgoi Mine. The asset retirement obligations are calculated as the net present value of estimated future net cash flows of the reclamation and closure costs, which total $2,826,421and are required to satisfy the obligations, discounted using a risk free rate of 11.46%. The settlement of the obligations will occur through to 2025.

The following is an analysis of the asset retirement obligation:

| | | |
|---|---|---|
| Balance, As at January 1, 2007 | $ | - |
| Additions | | - |
| Accretion | | - |
| Balance, As at December 31, 2007 | | - |
| Additions | | 308,731 |
| Accretion | | 19,498 |
| Balance, As at December 31, 2008 | | 328,229 |
| Additions | | 77,743 |
| Accretion | | 19,926 |
| **Balance, As at June 30, 2009** | **$** | **425,898** |

## 17. SHARE CAPITAL

### 17.1 Common and preferred shares

| | |
|---|---|
| Authorized | Unlimited common shares with no par value<br>Unlimited preferred shares with no par value |
| Issued and outstanding | 133,367,382 (2008 – 133,193,282) common shares<br>Nil (2008 - nil) preferred shares |

Refer to Consolidated Statement of Changes in Equity for movement in share capital for the six months ended June 30, 2009.

## 17. SHARE CAPITAL (Continued)

### 17.2 Preferred shares

On May 29, 2007, upon completion of the coal transaction (Note 21), the Company issued 25,576,383 preferred shares to Ivanhoe. Each preferred share issued to Ivanhoe was convertible into one common share but only if, upon any such conversion, the total number of common shares held by Ivanhoe and all other insiders of the Company or any of their respective associates or affiliates did not exceed 90% of the total number of common shares then issued and outstanding. The preferred shares were non-voting and had a preference over the common shares with respect to the payment of dividends and distribution of assets in the event of a liquidation, dissolution or winding up of the Company.

On January 23, 2008, Ivanhoe converted 25,576,383 preferred shares into common shares of the Company on a one to one basis. The Company has no outstanding preferred shares at June 30, 2009.

## 18. SHARE-BASED PAYMENTS

### 18.1 Stock option plan

The Company has a stock option plan which permits the Board of Directors of the Company to grant options to acquire common shares of the Company at the greater of the 15% discounted closing trading price on the date of the grant or the volume weighted average closing price for the five days preceding the date of grant. The Amended Equity Incentive Plan, approved on May 29, 2007, provides for a rolling rather than a fixed maximum number of common shares which may be issued pursuant to incentive stock options and other equity incentives, awards and issuances. The Compensation and Benefits Committee determines and makes recommendations to the Board of Directors as to the recipients of, and nature and size of, share-based compensation awards in compliance with applicable securities law, stock exchange and other regulatory requirements. The Company is authorized to issue options for a maximum of 10% of the issued and outstanding common shares pursuant to the stock option plan.

## 18. SHARE-BASED PAYMENTS (Continued)

### 18.1 Stock option plan (continued)

The stock option plan permits the Board of Directors of the company to set the terms for each stock option grant, however, the general terms of stock options granted under the amended plan include a maximum exercise period of 5 years and a vesting period of 3 years with one-third of the grant vesting on the first anniversary of the grant, one-third vesting on the second anniversary of the grant and one-third vesting on the third anniversary of the grant. The options granted in the six months ended June 30, 2009 were granted with a weighted average maximum exercise period of 5.96 years and a weighted average vesting period of 1.63 years.

During the six months ended June 30, 2009, the Company granted 1,300,000 (2008 – 934,000) stock options to officers, employees and directors at exercise prices ranging from Cdn$7.94 to Cdn$11.46 and expiry dates ranging from May 6, 2014 to February 6, 2016 (2008 – exercise prices ranging from Cdn$7.16 to Cdn$16.57 and expiry dates ranging from January 7, 2013 to June 5, 2013). The weighted average fair value of the options issued the six months ended June 30, 2009 was estimated at $4.41 (Cdn$5.26) per option at the grant date using the Black-Scholes option pricing model. The weighted average assumptions used for the calculation were:

| | Six months ended June 30, 2009 | Year ended December 31, 2008 |
|---|---|---|
| Risk free interest rate | **1.92%** | 2.78% |
| Expected life | **4 years** | 3 years |
| Expected volatility (i) | **80%** | 74% |
| Expected dividend per share | **$nil** | $nil |

(i) Expected volatility has been based on historical volatility of the Company's publicly trade shares.

A share-based compensation cost of $5,425,343 for the options granted in the six months ended June 30, 2009 (2008 - $6,269,901) will be amortized over the vesting period, of which $1,289,406 was recognized in the six months ended June 30, 2009 (2008 - $888,630).

The total share-based compensation calculated for the six months ended June 30, 2009 was $7,117,769 (2008 - $2,908,665). Share-based compensation of $5,847,132 (2008 - $1,271,189) has been allocated to Salaries and benefits, $995,659 (2008 - $nil) has been allocated to Operating expenses and $274,978 (2008 - $1,637,476) has been allocated to Evaluation and exploration expenses.

## 18. SHARE-BASED PAYMENTS (Continued)

### 18.2 Outstanding stock options

The following is a summary of option transactions under the Company's stock option plan:

| | **Six months ended June 30, 2009** | | **Year ended December 31, 2008** | |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price (Cdn$) | Number of options | Weighted average exercise price (Cdn$) |
| Balance, beginning of period | **6,586,055** | **7.18** | 4,994,632 | 3.55 |
| Options granted | **1,300,000** | **9.25** | 3,184,000 | 11.27 |
| Options exercised | **(174,100)** | **2.65** | (1,442,244) | 2.80 |
| Options forfeited | **(134,670)** | **5.62** | (150,333) | 15.25 |
| **Balance, end of period** | **7,577,285** | **7.67** | 6,586,055 | 7.18 |

The following table summarizes information about stock options outstanding and exercisable at June 30, 2009:

| | **Options Outstanding** | | | **Options Exercisable** | | |
|---|---|---|---|---|---|---|
| Exercise price (Cdn$) | Options outstanding | Weighted-average exercise price (Cdn$) | Weighted-average remaining contractual life (years) | Options outstanding and exercisable | Weighted-average exercise price (Cdn$) | Weighted-average remaining contractual life (years) |
| $0.86 - $2.85 | 1,685,966 | $ 1.99 | 1.78 | 1,685,966 | $ 1.99 | 1.78 |
| $3.70 - $6.00 | 2,634,819 | 5.58 | 3.60 | 1,484,819 | 5.94 | 2.97 |
| $7.16 - $13.80 | 2,156,500 | 10.12 | 4.91 | 558,417 | 10.96 | 4.55 |
| $15.07 - $18.86 | 1,100,000 | 16.58 | 4.09 | 33,333 | 16.57 | 3.93 |
| | 7,577,285 | $ 7.67 | 3.64 | 3,762,535 | $ 5.01 | 2.68 |

## 19. ACCUMULATED DEFICIT AND DIVIDENDS

The Company has incurred losses since inception and at June 30, 2009 the Company has accumulated a deficit of $228,575,469 (at December 31, 2008 - $213,322,459).

No dividends have been paid or declared by the Company since inception.

## 20. RELATED PARTY TRANSACTIONS

The financial statements include the financial statements of SouthGobi Energy Resources Ltd. and its subsidiaries listed in the following table:

| | | % equity interest | | |
|---|---|---|---|---|
| | | As at | | |
| | Country of | June 30, | As at December 31, | |
| **Name** | **incorporation** | **2009** | **2008** | **2007** |
| Asia Gold International Holding Company Ltd. | British Virgin Islands | 100% | 100% | 100% |
| Dayarbulag LLC | Mongolia | 100% | 100% | 100% |
| SouthGobi Sands LLC | Mongolia | 100% | 100% | 100% |
| Transbaikal Gold | Russia | 100% | 100% | 100% |
| SGQ Coal Investment Pte. Ltd. | Singapore | 100% | 100% | 100% |
| SGQ Dayarcoal Mongolia Pte. Ltd. | Singapore | 100% | 100% | 100% |
| SGQ Singapore Investment Company Pte. Ltd. | Singapore | 100% | 100% | 100% |
| SouthGobi Energy Resources (Hong Kong) Ltd. | Hong Kong | 100% | - | - |
| PT Multi Mamahak Batubara | Indonesia | 85% | 85% | - |
| SGQ Batubara (A) Pte. Ltd. | Singapore | 85% | 85% | - |
| Bacan Holding Company Ltd. | British Virgin Islands | - | 100% | 100% |
| Ivanhoe Coal Holding Company Ltd. | British Virgin Islands | - | - | 100% |
| Mongolia Holding Company Ltd. | British Virgin Islands | - | 100% | 100% |
| Arkadia Indonesia Holding Company Ltd. | British Virgin Islands | - | 100% | 100% |
| Ivanhoe Resources Ltd. | Canada | - | - | 100% |
| PT AGC Indonesia | Indonesia | - | 100% | 100% |
| PT ASG Harita Mining Services | Indonesia | - | 85% | 85% |
| Asia Gold Mongolia LLC | Mongolia | - | 100% | 100% |
| Bacan Indonesia Holding Company Pte. Ltd. | Singapore | - | 100% | 100% |
| SGQ Indonesia Holding Company Pte. Ltd. | Singapore | - | 100% | 100% |
| SGQ Mongolia Holding Ltd. | Singapore | - | 100% | 100% |
| SGQ Singapore Projects Holding Company Pte. Ltd. | Singapore | - | 100% | 100% |

## 20. RELATED PARTY TRANSACTIONS (Continued)

### 20.1 Related party expenses

The Company incurred the following expenses with Ivanhoe, I2MS.NET PTE LTD ("I2MS") and Global Mining Management ("GMM"), companies related by way of directors or shareholders in common. As at June 30, 2009, Ivanhoe owned approximately 80% of the outstanding common shares of the Company.

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Corporate administration | **$ 296,610** | $ 158,448 | **$ 525,556** | $ 318,103 |
| Salaries and benefits | **338,720** | 786,866 | **638,762** | 1,143,261 |
| Interest (Note 15) | **344,954** | - | **397,695** | 7,955,993 |
| **Total related party expenses** | **$ 980,284** | $ 945,314 | **$ 1,562,013** | $ 9,417,357 |

The corporate administration and salaries and benefits have been recorded on a cost recovery basis and the interest expense has been recorded on the contractual amount basis.

The breakdown of the expenses between the different related parties is as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| GMM | **$ 474,648** | $ 945,314 | **$ 882,746** | $ 1,461,364 |
| Ivanhoe | **344,954** | - | **397,695** | 7,955,993 |
| I2MS | **160,682** | - | **281,572** | - |
| **Total related party expenses** | **$ 980,284** | $ 945,314 | **$ 1,562,013** | $ 9,417,357 |

### 20.2 Related party assets

The assets of the Company include the following amounts due from related parties:

| | As at June 30, | As at December 31, | |
|---|---|---|---|
| | **2009** | **2008** | **2007** |
| Amounts due from GMM | **$ 54,167** | $ - | $ - |

## 20. RELATED PARTY TRANSACTIONS (Continued)

### 20.3 Related party liabilities

The liabilities of the Company include the following amounts due to related parties:

| | As at June 30, 2009 | As at December 31, 2008 | As at December 31, 2007 |
|---|---|---|---|
| Amounts due for administration to GMM | **$ 255,569** | $ 230,712 | $ 211,045 |
| Accounts payable to Ivanhoe | **18,780** | 60,682 | 52,045 |
| Accounts payable to I2MS | **191,082** | 285,372 | - |
| Deposit received for sale of metals division | **-** | 3,000,000 | - |
| Amounts due under line of credit facilities | **24,397,695** | - | 105,673,380 |
| **Total liabilities due to related parties** | **$24,863,126** | $ 3,576,766 | $ 105,936,470 |

## 21. COAL TRANSACTION

In July 2006, the Company and Ivanhoe signed a definitive agreement, effective April 26, 2006, whereby the Company agreed to acquire Ivanhoe's coal division (the "Coal Transaction") in exchange for 57,000, 000 common shares and 25,576,383 preferred shares of the Company.

On August 8, 2006, the Coal Transaction and the equity conversion rights under the line of credit facility (Note 15) were approved by the Company's minority shareholders at a special meeting convened for that purpose.

The Coal Transaction, which was a related party transaction, received final approval from the TSX Venture Exchange on May 28, 2007.

On May 29, 2007, the Company completed the purchase of the Ivanhoe coal division. The common shares issued to Ivanhoe, when aggregated with Ivanhoe's existing holding of common shares, represented approximately 86% of the total number of common shares currently issued and outstanding. The coal rights and licenses acquired by the Company have been recorded at $nil as the underlying assets had no carrying amount within the coal division.

With the completion of the Coal Transaction, certain coal division expenditures made by Ivanhoe between April 26, 2006 and May 29, 2007 were added to the indebtedness outstanding under the line of credit and will be repayable by the Company as if they were advances. The total coal expenditures funded by Ivanhoe from April 26, 2006 to May 28, 2007, and accepted by SouthGobi, are approximately $13.2 million of which $13 million are related to exploration expenses and $200,000 are for plant and equipment.

The Coal Transaction is considered a combination between businesses or entities under common control and is therefore exempt from the scope of IFRS 3 '*Business Combinations'*. The Company has accounted for the Coal Transaction using the principles of merger accounting and the prior periods were restated as if the Company and the coal division had always been combined. The coal division consists of certain coal related assets and expenditures made by Ivanhoe from its inception in 2004 to May 29, 2007. Note 3(i) to the financial statements provides detailed disclosure of the impact of the principles of merger accounting.

## 22. SUPPLEMENTAL CASH FLOW INFORMATION

### 22.1 Non-cash financing and investing activities

In the three and six months ended June 30, 2009 the Company incurred the following non-cash investing and financing transactions:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Conversion of line of credit facility (first funding agreement) (Note 15.4) | **$ -** | $ - | **$ -** | $ 107,551,903 |
| Conversion of preferred shares to common shares | **-** | - | **-** | 4,189,154 |
| Transfer of share option reserve upon exercise of options | **86,416** | 730,426 | **283,574** | 1,505,060 |
| **Total non-cash financing and investing activities** | **$ 86,416** | $ 730,426 | **$ 283,574** | $ 113,246,117 |

### 22.2 Cash payments for interest and taxes

In the three and six months ended June 30, 2009 the Company made the following cash payments for interest and income taxes:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Interest paid | **$ -** | $ - | **$ -** | $ 77,470 |
| Taxes paid | **-** | - | **-** | - |
| **Total cash payments** | **$ -** | $ - | **$ -** | $ 77,470 |

## 23. COMMITMENTS FOR EXPENDITURE

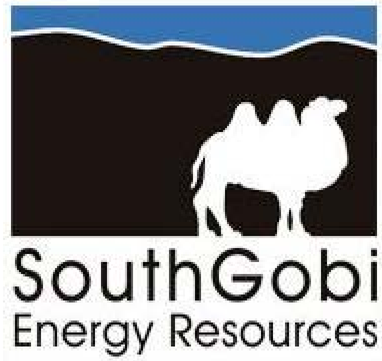
At June 30, 2009, the Company had outstanding commitments of $10.6 million for coal mining equipment and buildings. Included in the $10.6 million is $5.9 million for the purchase of a second fleet of coal mining equipment for the development of its Ovoot Tolgoi Project in Mongolia. Delivery and commissioning of the equipment is scheduled for the third quarter of 2009. The Company also has the option to purchase truck and shovel fleets for delivery in 2010 and 2011 with prices to be negotiated at the time of the orders.

## 24. SUBSEQUENT EVENTS

In July 2009, the Company and Ivanhoe agreed to increase the existing working capital credit facility from $30 million to $60 million. The amended credit facility will mature on December 31, 2010, is unsecured and bears interest at LIBOR plus 750 basis points. The amended facility also requires repayment in the event that the Company acquires additional financing from a third party source and provides for an extension fee of $1.5 million payable in the event any portion of the facility is outstanding past March 31, 2010.

## 25. APPROVAL OF THE FINANCIAL STATEMENTS

The Consolidated Interim Financial Statements of SouthGobi Energy Resources Ltd. for the six months ended June 30, 2009 were approved and authorized for issue by the Audit Committee on August 5, 2009.




# SouthGobi Energy Resources Ltd.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**June 30, 2009**

(Stated in U.S. dollars)

**SOUTHGOBI ENERGY RESOURCES LTD**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**
**June 30, 2009**
**(Unaudited)**
**(Stated in U.S. Dollars)**

## OVERVIEW

SouthGobi Energy Resources Ltd., (which, together with its subsidiaries, is collectively referred to as the "Company" or "SouthGobi") is an integrated coal development company. Since acquiring significant coal assets in Mongolia in a series of transactions (the "coal transaction") with Ivanhoe Mines Ltd ("Ivanhoe"), the Company's strategic focus has been developing and operating coal mining projects.

The Company's common shares trade on the TSX Venture Exchange ("TSX-V") under the symbol SGQ.

Prior to the coal transaction, the Company was a mineral exploration company with a focus on precious and base metal exploration and development in Mongolia, and elsewhere. Having completed the coal transaction in May 2007 and with the sale of its Metals Division to Ivanhoe as of December 30, 2008, the Company's principal focus is now on its Mongolian coal operation at Ovoot Tolgoi and coal exploration and development in southern Mongolia and Indonesia.

### Recent Developments

#### Ovoot Tolgoi Project Development

Coal shipments commenced in late September 2008, and continued throughout the fourth quarter of 2008. In January and February 2009, the Company experienced difficulty expediting the movement of its coal shipments through the Mongolia-China border at Ceke due to erratic and unpredictable opening hours and sporadic closures of the relatively informal border point. As a result, the Company initiated a production curtailment program in January 2009, decreasing production to preserve cash and to manage stockpiles.

The Company continued coordinating efforts with the Mongolian Government and various agencies to improve border crossing access for coal shipments. On February 24, 2009 in a further effort to minimize costs, the Company shut down production at the Ovoot Tolgoi operation. All production equipment was demobilized, except for coal loading of customer trucks from the coal stockpile.

As discussions continued with the Mongolian Government, border access improved towards the end of the first quarter of 2009. In March 2009, the border point started operating on a more formal basis, with a schedule of eight hours per day, seven days per week. This resulted in increased shipments for the month of March, with sales of over 115,000 tonnes of coal. In April and May 2009, shipments totaled approximately 152,000 tonnes. In June, the border started operating at 11 hours per day, six days per week. Total shipments in June were approximately 232,000 tonnes, a new record for the Company. In July 2009, Mongolian and Chinese officials met at the Mongolian-Chinese border and allocated gates for coal export to create a designated coal corridor.

With increasing sales and a reduction in its coal inventory, the Company has resumed full mining operations effective July 1, 2009 on a 24 hour per day, seven day per week basis.

Work continues on the construction of the permanent man camp and permanent shop facility, which are scheduled for completion in the third quarter. The mine airstrip surfacing has been completed and final permitting was received for the concrete airstrip.

In January 2009, the Mongolian Government formally recognized the Company's extensive exploration program and timely government reporting process with two separate awards.

In July 2008, the Company announced that it had received an updated resource estimate in respect of the West Field portion of the Ovoot Tolgoi coal project in Mongolia from an independent third party technical consultant. The consultant subsequently advised the Company, and the Company announced in March 2009, that errors had been discovered in the resource estimate and that these errors resulted in an overstatement of the resources in the West Field reported by the Company in July 2008, primarily in the indicated and inferred categories. In the March 2009 announcement, the Company published a corrected resource estimate and further noted that current mining plan and operations are not impacted by the revision. See "MINERAL PROPERTIES – Properties in Mongolia – Ovoot Tolgoi Open Pit Project".

**Mamahak Project Development**

In April 2008, the Company entered into a Joint Venture Earn-In Agreement with an Indonesian company to explore and develop a coal project in East Kalimantan, Indonesia, known as the Mamahak coal project ("MCM"). In September 2008, based on positive exploration results, the Company increased its working interest in MCM to 85%.

In early January 2009, the Company announced that a location permit was issued, which allows the Company to commence surface coal mining on MCM.

In February 2009, the Company announced that it had received an initial resource estimate from its independent consultants, SMG Consultants ("SMG") in respect of the E resource block and the SW resource block on the MCM concession. The Company filed a technical report supporting the resource estimate in March 2009, which is available at www.sedar.com. See "MINERAL PROPERTIES – Properties in Indonesia – Mamahak Coal Project".

In May 2009, the Company completed an agreement with Glencore International AG ("Glencore") to provide coking coal marketing expertise and river barging/vessel loading logistical services for MCM. The mine, infrastructure and barge load out are nearing completion. In the current quarter, the Company engaged two smaller mining contractors, who have significant experience in operations similar to Mamahak, to conduct mine development.

The Company plans to ship a test cargo of approximately 30,000 tonnes to a customer in the third quarter.

Prior to the enactment of a new law on mineral and coal mining in 2009, known as Minerba, foreign participation was effected via a number of contractual structures that allowed for indirect participation in mining concessions in Indonesia. Minerba, which was signed by the President of the Republic of Indonesia and became effective on January 12, 2009, introduced a new licensing system for mining concessions in Indonesia. The new system allows foreign companies to own mining concessions in Indonesia. On July 1, 2009, the Company acquired ownership of MCM which holds the mining concessions.

**Corporate Activity**

On December 31, 2008, the Company announced the sale of its Metals Division to Ivanhoe for $3 million and other non-cash consideration, with an effective date of December 30, 2008 and a closing date of February 2, 2009. As part of the transaction, the Company obtained a $30 million working capital credit facility from Ivanhoe.

On February 10, 2009, the Company announced the appointment of Alexander Molyneux as its new President, effective April 27, 2009. Based in Hong Kong, he was most recently Managing Director, Head of Metals & Mining Investment Banking, Asia Pacific, Citigroup.

On March 20, 2009, the Company announced two new appointments to its Management and Resource Development team: Jess Harding and Stephen Torr.

Jess Harding has been appointed the Company's Vice-President, Evaluations and Project Development. Mr. Harding has more than 15 years' experience in the mining industry and assumes the same role that he presently holds at Ivanhoe Mines Ltd. Mr. Harding has a Bachelor of Chemical Engineering from the University of Leeds, UK.

Stephen Torr, (P.Geo.), has been appointed the Company's Resource Manager. Mr. Torr has 19 years of experience in the mining industry and currently is the Resource Manager for Ivanhoe Mines Ltd. Mr. Torr has a B.Sc. (Hons) Degree in Geology from the University of Southampton and a M.Sc. in Applied Geoscience from the University of Leicester. Mr Torr has previous experience in estimation of open pit and underground coal resources and will be assuming the role of Qualified Person to oversee future independent resource estimates for SouthGobi.

In June 2009, Jay Gow was appointed the Company's Vice-President, Coal Marketing. Mr. Gow has extensive experience in international and domestic resource marketing, which will be important as the Company develops its international customer base in Asia, Europe and the Americas.

In July 2009, the Right Honourable Jean Chretien, the 20th Prime Minister of Canada, was appointed as a senior international adviser to the Company as part of a broader engagement of Mr. Chretien's services by Ivanhoe and certain other companies with which the Company shares access to corporate administrative facilities, employees and service providers. See "Related Party Transactions". Mr Chretien is expected to advise the Company with respect to international business opportunities in the energy and mineral resource sectors.

In July 2009, the Company announced the resignation of Gene Wusaty as the Company's Chief Operating Officer. Mr. Wusaty is leaving SouthGobi to pursue other business opportunities. The Company has retained an executive search firm and is in an advanced stage with respect to sourcing a new Chief Operating Officer.

In July 2009, the Company and Ivanhoe agreed to increase an existing working capital credit facility from $30 million to $60 million. The amended credit facility will mature on December 31, 2010, is unsecured and bears interest at LIBOR plus 750 basis points. The amended facility also requires repayment in the event that the Company acquires additional financing from a third party source and provides for an extension fee of $1.5 million payable in the event any portion of the facility is outstanding past March 31, 2010. This additional $30 million working capital facility will allow the Company to continue to fund its expansion plans and current operations in Mongolia and Indonesia.

Effective September 1, 2009 Denis Lehoux, the Company's in country Operations Director in Mongolia will be retiring. David Bartel, who has been with the Company since January 2007, has been appointed Operations Director and Vice President. Mr. Bartel has over 30 years of experience in the coal industry and will be the key representative for the Company in Mongolia.

Ivanhoe, directly and indirectly, currently owns 106,607,155 common shares representing approximately 80% of the issued and outstanding common shares of SouthGobi.

## FORWARD LOOKING STATEMENTS

Except for statements of fact relating to the Company, certain information contained herein constitutes forward-looking statements. Forward-looking statements are frequently characterized by words such as "plan", "expect", "project", "intend", "believe", "anticipate" and other similar words, or statements that certain events or conditions "may" or "will" occur. Forward-looking statements are based on the opinions and estimates of management at the dates the statements are made, and are subject to a variety of risks and uncertainties and other factors that could cause actual events or results to differ materially from those projected in the forward-looking statements. These factors include the inherent risks involved in the exploration and development of mineral properties, the uncertainties involved in interpreting drilling results and other geological data, fluctuating metal prices, the possibility of project cost overruns or unanticipated costs and expenses, uncertainties related to completion results of planned exploration and development programs on the Company's material properties, issuance of licenses and permits and the availability of and costs of financing needed in the future and other factors described in this discussion under the heading "Outlook". Except as required by law, the Company undertakes no obligation to update forward-looking statements if circumstances or management's estimates or opinions should change. The reader is cautioned not to place undue reliance on forward-looking statements.

## INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

### Transition to IFRS from GAAP

In February 2008, the Canadian Accounting Standards Board confirmed that Canadian publicly accountable enterprises will be required to adopt International Financial Reporting Standards ("IFRS") for financial periods beginning on and after January 1, 2011. In the Canadian Securities Administrators ("CSA") Staff Notice 52-321 – Early Adoption of International Financial Reporting Standards, Use of US GAAP and Reference to IFRS-IASB, CSA has indicated that it would be prepared to provide exemptive relief to permit a Canadian reporting issuer to prepare its financial statements in accordance with IFRS for financial periods beginning before January 1, 2011.

As previously disclosed, the Company is in the application process for a secondary listing of its common shares on an Asian stock exchange. As part of the application process, the Company is required to provide financial statements under IFRS with three years of comparative data. In order to produce the required International Accounting Standards Board ("IASB") financial statements the Company has produced 2008 interim IFRS statements with an IFRS adoption date of January 1, 2009 and IFRS transition date of January 1, 2005. As per Appendix A of IFRS 1 "An entity cannot have more than one set of IFRS financial statements. Therefore, it must have only one starting point for transition to IFRS". In March 2009, the Company was granted exemptive relief by Canadian securities regulatory authorities under Staff Notice 52-321 and has been permitted to adopt IFRS for Canadian reporting purposes for reporting periods beginning on or after January 1, 2009. The Company has adopted IFRS with an adoption date of January 1, 2009 and a transition date of January 1, 2005.

### IFRS Conversion

The Company's IFRS conversion plan was comprehensive and addressed matters including changes in accounting policies, restatement of comparative periods, organizational and internal controls and any required changes to business processes. To facilitate this process and ensure the full impact of the conversion was understood and managed reasonably, the Company retained an external third party accounting firm and hired an IFRS conversion project manager. The accounting staff attended several training courses on the adoption and implementation of IFRS. Through in-depth training and the preparation of reconciliations of historical Canadian GAAP financial statements to IFRS, the Company believes that its accounting personnel have obtained a thorough understanding of IFRS. Further, the accounting personnel at our Mongolian and Indonesian subsidiaries are already familiar with IFRS and have been working with IFRS due to either local adoption of IFRS or convergence of local standards to IFRS in those jurisdictions.

In conjunction with the adoption of IFRS the Company has implemented a new accounting system, which will satisfy all the information needs of the Company under IFRS. The Company has also reviewed its current internal and disclosure control processes and believes they will not need significant modification as a result of our conversion to IFRS.

### Impact of IFRS

IFRS employs a conceptual framework that is similar to Canadian GAAP; however significant differences exist in certain matters of recognition, measurement and disclosure. While the adoption of IFRS will not change the actual cash flows of the Company, the adoption will result in changes to the reported financial position and results of operations of the Company. In order to allow the users of the financial statements to better understand these changes, we have provided the reconciliations between Canadian GAAP and IFRS for the total assets, total liabilities, shareholders equity and net earnings in

Note 3 to the Consolidated Interim Financial Statements. The adoption of IFRS has had no significant impact on the net cash flows of the Company. The changes made to the statements of financial position and comprehensive income have resulted in reclassifications of various amounts on the statements of cash flows, however as there has been no change to the net cash flows, no reconciliations have been presented.

In preparing the reconciliations, the Company applied the principles and elections of IFRS 1, with a transition date of January 1, 2005, consistent with those assumed in our application documentation for the listing on the Asian stock exchange. As the Company has been permitted to adopt IFRS effective January 1, 2009, it will apply the provisions of IFRS 1 as described under the section entitled "Initial Adoption – IFRS 1", with a January 1, 2005 transition date. The Company will also apply IFRS standards in effect at December 31, 2009 as required by IFRS 1.

**Initial Adoption of International Accounting Standards**

IFRS 1 ''First Time Adoption of International Accounting Standards'' sets forth guidance for the initial adoption of IFRS. Under IFRS 1 the standards are applied retrospectively at the transitional date of the statement of financial position with all adjustments to assets and liabilities as stated under GAAP taken to retained earnings unless certain exemptions are applied. The Company is not applying any exemptions on first-time adoption.

**Comparative Information**

The Company has restated all prior period figures in accordance with IFRS.

## CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with International Financial Reporting Standards requires the Company to establish accounting policies and to make estimates that affect both the amount and timing of the recording of assets, liabilities, revenues and expenses.

A detailed summary of all of the Company's significant accounting policies is included in Note 4 to the Consolidated Interim Financial Statements for the three and six months ended June 30, 2009. Note 3 to the Consolidated Interim Financial Statements for the three and six months ended June 30, 2009 provides a review of the significant changes to the reported financial position and results of operations of the Company under Canadian GAAP and IFRS.

The following is an outline of the estimates that the Company considers as critical in the preparation of its consolidated financial statements.

### Mineral Property and Exploration Costs

All direct costs related to the acquisition of mineral property interests are capitalized into intangible assets on a property by property basis. Exploration costs, net of incidental revenues, are charged to operations in the period incurred until such time as it has been determined that a property has economically recoverable reserves, in which case subsequent exploration costs and the costs incurred to develop a property are capitalized into property, plant and equipment ("PPE"). Exploration costs include value-added taxes incurred in foreign jurisdictions when recoverability of these taxes is uncertain. On the commencement of commercial production, depletion of each mining property will be provided on a unit-of-production basis using estimated resources as the depletion base.

At each date of the statement of financial position, the Company reviews the carrying values of its mineral property interests to determine whether there is an indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). Recoverable amount is the higher of fair value less costs to sell and value in use. If the recoverable amount is estimated to be less than its carrying amount, the carrying amount is reduced to its recoverable amount.

### Decommissioning, restoration and similar liabilities (Asset retirement obligation or "ARO")

The Company recognizes liabilities for statutory, contractual, constructive or legal obligations, including those associated with the reclamation of mineral properties and PPE, when those obligations result from the acquisition, construction, development or normal operation of the assets. Initially, a liability for an asset retirement obligation is recognized as its fair value in the period in which it is incurred. Upon initial recognition of the liability, the corresponding asset retirement obligation is added to the carrying amount of the related asset and the cost is amortized as an expense over the economic life of the asset using either the unit-of-production method or the straight-line method, as appropriate. Following the initial recognition of the asset retirement obligation, the carrying amount of the liability is increased for the passage of time and adjusted for changes to the current market-based discount rate, amount or timing of the underlying cash flows needed to settle the obligation.

### Inventory valuation

Coal inventories are stated at lower of production cost and net realizable value. Production costs include direct and indirect labour, operating materials and supplies, transportation costs and an appropriate portion of fixed and variable overhead expenses, including depreciation and depletion. Net

realizable value represents the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

Supplies inventory consists of consumable parts and supplies which are valued at lower of average cost and net realizable value. Supplies used in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. Net realizable value is defined as the selling price of the finished product less any provisions for obsolescence and costs of completion.

**Stripping costs**

Stripping costs incurred during the development of a mine are capitalized into PPE. Stripping costs incurred during the production phase are variable production costs that are included in the costs of inventory produced during the period that the stripping costs are incurred, unless the stripping activity can be shown to give rise to future benefits from the mineral property, in which case the stripping costs would be capitalized into PPE. Future benefits arise when stripping activity increases the future output of the mine by providing access to a new ore body. Capitalized stripping costs are depleted on a unit-of production basis, using estimated resources as the depletion base.

**Income taxes**

Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates used to compute the amount are those that are enacted or substantively enacted by the date of the statement of financial position.

Deferred income tax is provided using the liability method on temporary differences at the date of the statement of financial position between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

**Stock-based compensation**

The Company accounts for stock options granted to directors, officers, employees and service providers using the Black-Scholes option pricing model. Option pricing models require the input of highly subjective assumptions regarding the expected volatility. Changes in assumptions can materially affect the fair value estimate, and therefore, the existing models do not necessarily provide a realistic measure of the fair value of the Company's stock options at the date of the grant or thereafter.

**Revenue recognition**

Sales revenues are recognized when the risk and rewards of ownership pass to the buyer, collection is reasonably assured and the price is reasonably fixed and determinable. This occurs when the coal is either loaded onto a truck or when it is unloaded at the final destination, depending on the terms of the contract.

**Depletion and depreciation of property, plant and equipment**

Property, plant and equipment comprise the largest component of the Company's assets and, as such, the depreciation of these assets has a significant effect on the Company's financial statements.

On the commencement of commercial production, depletion of each individual mining property is provided on the unit-of-production basis using estimated resources as the depletion basis.

The mining equipment and other capital assets are depreciated, over their expected economic lives using either the unit-of-production or straight-line method. Capital projects in progress are not depreciated until the capital asset has been put into operation.

The estimates of the resources for the depletion basis are determined based on professional evaluation, but may change based on additional knowledge gained subsequent to the initial assessment. A change in the original resource estimates would result in a change in the rate of depletion of the related mining assets.

## CHANGE IN ACCOUNTING POLICIES

On January 1, 2009, the Company adopted IFRS. The provisions of new and revised standards and interpretations are applicable and effective for the Company's financial year beginning on or after January 1, 2009.

A summary of the new and revised standards and interpretations are outlined in Note 2.3 of the Consolidated Interim Financial Statements for the six months ended June 30, 2009.

## NON-IFRS FINANCIAL MEASURES

($ in thousands, unless otherwise stated)

This Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") refers to certain financial measures, such as "cash costs", which are not standardized measures recognized under IFRS and do not have a standardized meaning prescribed by IFRS. These measures are commonly utilized in the mining industry and are considered informative for management, shareholders and analysts. These measures may differ from those made by other corporations and accordingly may not be comparable to such measures as reported by other mining companies.

Cash costs is the term used by the Company to describe the cash production costs and consists of cost of product, which includes direct and indirect costs of production.

Prior year comparatives are not provided as the Company did not have sales in the six months ended June 30, 2008.

| | **Three Months Ended** | | **Six Months Ended** |
|---|---|---|---|
| | **June 30, 2009** | March 31, 2009 | **June 30, 2009** |
| **Cash costs, continuing operations** | | | |
| Cost of sales per financial statements | **$ 9,139** | $ 3,213 | **$ 12,352** |
| Less non-cash adjustments | **(2,171)** | (855) | **(3,026)** |
| Total cash costs | **6,968** | 2,358 | **9,326** |
| Coal sales *(tonnes)* | **384,305** | 127,366 | **511,671** |
| Total cash costs of product sold *(per tonne)* | **$ 18.13** | $ 18.51 | **$ 18.23** |

| | **Three Months Ended** | | **Six Months Ended** |
|---|---|---|---|
| | **June 30, 2009** | March 31, 2009 | **June 30, 2009** |
| **Cash costs, continuing operations** | | | |
| Direct cash costs of product sold *(per tonne)* | **$ 16.64** | $ 14.29 | **$ 16.05** |
| Mine administration cash costs of product sold *(per tonne)* | **1.49** | 4.22 | **2.18** |
| Total cash costs of product sold *(per tonne)* | **$ 18.13** | $ 18.51 | **$ 18.23** |

## MINERAL PROPERTIES

### Qualified Persons

Disclosure of a scientific or technical nature in this MD&A with respect to the Company's Coal Division was prepared by, or under the supervision of Gene Wusaty, P.Eng, and Chief Operating Officer, and Stephen Torr (P.Geo.) and Resource Manager. Each of Messrs. Torr and Wusaty is a "qualified person" for the purposes of National Instrument 43-101 of the Canadian Administrators ("NI 43-101").

Mr. Torr was appointed the Company's Resource Manager on March 20, 2009.

### Coal Group Profile

#### Mongolia Exploration Licenses

The coal transaction was completed in May 2007, when the Company acquired Ivanhoe's Coal Division, including Ivanhoe's entire interest in the Ovoot Tolgoi (formerly Nariin Sukhait) coal development project, the Tsagaan Tolgoi coal exploration project and various coal exploration projects in Mongolia. To complete the transaction, 35 coal exploration licenses held by Ivanhoe, along with other assets and personnel, were transferred to the Company. The Company already owned a further 19 exploration licenses with coal potential, and with the additional 35 licenses, a total of 54 licenses covering an area of approximately 2.1 million hectares (" ha") were then available for coal exploration.

The Company regularly targets and prioritizes a number of licenses on the basis of potential, age, and cost.

As at July 17, 2009, the Company held 35 licenses, which in total cover an area of approximately 1.4 million ha.

Unless stated otherwise, the Company has a 100% interest in its coal projects.

### Properties in Mongolia

#### Ovoot Tolgoi Open Pit Project

The Ovoot Tolgoi coal deposit is located in the southwest corner of the Omnogovi Aimag (South Gobi Province) of Mongolia. The deposit is within the administrative unit of Gurvantes Soum, 320 km southwest of the provincial capital of Dalanzadgad and 950 km south of the nation's capital of Ulaanbaatar.

The Nariin Sukhait property was renamed "Ovoot Tolgoi" to differentiate the Company's coal exploration and development project in Mongolia's South Gobi Province from the adjoining Nariin Sukhait coal mine owned by the Mongolian-Chinese joint venture company, MAK/Qinhua.

Ivanhoe first initiated coal exploration in the Ovoot Tolgoi area in October 2004 and extensive exploration programs were also carried out in 2005, 2006 and 2007. Resources at the Ovoot Tolgoi property are found in two different areas, referred to as the South-East and the West Fields. The Company's independent consultant, Norwest Corporation ("Norwest") estimated that, as of December 31, 2006, the South-East Field hosted 49.8 million tonnes of measured resources, 15.9 million tonnes of indicated resources and 6.5 million tonnes of inferred resources. Norwest also estimated 55.1 million

tonnes of measured resources, 28.7 million tonnes of indicated resources and 22.6 million tonnes of inferred resources for the West Field.

In July 2008, the Company announced that its independent technical consultant, The Americas Group, Inc. ("TAG") of Lakewood, Colorado had prepared a new resource estimate for the West Field portion of the Ovoot Tolgoi coal project in Mongolia. TAG subsequently advised the Company, and the Company announced in March 2009, that errors had been discovered in the resource estimate and that these errors resulted in an overstatement of the resources in the West Field reported by the Company in July 2008, primarily in the indicated and inferred categories. The current resource estimates for the separate South-East Field and the Ovoot Tolgoi underground project were not affected by the errors. An amended report updating the resource estimate was filed on May 1, 2009 and is available at www.sedar.com.

The corrected West Field resource estimate is 75.0 million tonnes of measured resources, 27.7 million tonnes of indicated resources and 18.8 million tonnes of inferred resources.

The Company has engaged Norwest to complete a new technical report for the Ovoot Tolgoi project incorporating outstanding data obtained from drilling to the end of 2008, reflecting a redesign of the surface mine to a depth of 300 metres from the present 250 metres, updating the resource models and delineating reserves based on a pre-feasibility level of engineering. The Company expects to receive this report later in 2009. Management believes this new report will more fully demonstrate the potential of the Ovoot Tolgoi coal deposit.

The Company made considerable progress in identifying additional resources at Ovoot Tolgoi in 2008, drilling over 23,200 metres down to a depth of 800 metres in the West Field. In addition, there are 3,800 metres of drill data from 2007 in the South-East Field that still require modelling. Based on 2008 drill data, the coal potential is continuous along strike and at depth. Management is very encouraged by the results from the drilling completed in 2008 and believes that the data obtained will provide a basis for establishing additional resources.

Including the restated West Field resource estimate, the estimated combined resources for the South-East Field and the West Field of the Ovoot Tolgoi Project are shown in Table 3 below. The restated West Field resource estimate is based on data to June 20, 2008. The resource estimate for the South-East Field is based on data to December 31, 2006.

**Table 3: Restated Ovoot Tolgoi West Field and South-East Field In-Place Surface Coal Resources Summary**

| Resource Area | ASTM Coal Rank | Resources at Ovoot Tolgoi | | |
|---|---|---|---|---|
| | | Measured (tonnes) | Indicated (tonnes) | Inferred (tonnes) |
| **South-East Field** | **hvB to hvA** | 49,752,000 | 15,987,000 | 6,502,000 |
| **West Field** | **hvB to hvA** | 74,972,951 | 27,687,201 | 18,761,047 |
| **Total** | | **168,399,152** | | **25,263,047** |

The current mining plan and operations at Ovoot Tolgoi, which are based on an earlier estimate of the West Field coal resources as of December 31, 2006, are unaffected.

After obtaining its Permit to Mine on March 31, 2008, the Company started operations at Ovoot Tolgoi in April 2008. Coal shipments began in September 2008.

For the three month period ending June 30, 2009, the mine did not produce coal in order to reduce costs and coal inventory. Coal sales to December 31 2008 were approximately 113,000 tonnes. Coal shipments in the first quarter were approximately 127,000 tonnes. Coal sales in the second quarter were approximately 384,000 tonnes.

Due to erratic and unpredictable border openings, coal shipments in January and February 2009 were lower than expected. Consequently, and in order to preserve cash and manage stockpiles, a production curtailment program was initiated in January 2009 decreasing production to a dayshift basis. This was followed by a full mine shut down in late February 2009, except for coal loading of customer trucks from coal stockpiles.

The Company has been engaged in ongoing discussions with the Mongolian Government and various agencies, with the objective of establishing a border crossing at the Ceke border point that will be open for a full 24 hours per day, 365 days per year. This is expected to allow increasing daily distribution of Ovoot Tolgoi coal to customers in China. At present the border crossing operates on an eleven hour per day, six days per week basis. SouthGobi purchased an automated 150 tonne scale which has been set up at the border to expedite coal traffic crossing the border into China from Ovoot Tolgoi.

The Company employed 235 employees as at June 30, 2009. Of the 235 employees, 37, including expatriates, are employed in the Ulaanbaatar office, 7 in outlying smaller offices including the Ceke border point and 191 at the mine site. Of the 191 employees at the mine site, 105 employees were on a temporary layoff status due to the temporary production curtailment initiative at the mine site. Laid off employees were recalled on a systematic re-employment schedule in June 2009 to coincide with startup activities planned for July 2009. Of the total 235 employees based in Mongolia, 227 (97%) are Mongolian nationals and 58 (25%) are residents of the local Gurvantes Soum.

In April 2008, the Company purchased a second fleet of coal mining equipment for the open pit mine, which is scheduled to be commissioned in the fourth quarter. The new shovel / truck mining fleet consists of a Liebherr 996 hydraulic excavator (34 cubic m) and four Terex MT4400 (260-ton capacity) trucks. The new fleet will supplement the existing mine fleet consisting of a Liebherr 994 hydraulic excavator (13.5-cubic m capacity) and 7 Terex TR100 (100-ton capacity) trucks. The additional equipment is expected to be deployed alongside the existing mining fleet to expand capacity for the Ovoot Tolgoi mine.

Work on the new shop complex and mancamp at Ovoot Tolgoi continued throughout the second quarter. The airstrip surfacing project was completed at year end and was certified in early 2009. The mancamp and shop building completion is scheduled for the third quarter.

The Ovoot Tolgoi mine is 45 km north of Mongolia's border with China. A major Chinese regional conglomerate (including steel and power generating subsidiaries) was the major proponent in the construction of a north / south railway line to the Ceke border point, where a major automated railcar coal loading facility opened in 2007. A new east / west railway is proposed to be completed by end of 2009, which will connect the Ceke border point with China's main west to east coal transportation trunk route that runs all the way to ports in the Bohai Gulf. In December 2008, the Company entered into preliminary discussions with major railway contractors on the development of a coal railway from the Ovoot Tolgoi mine to a point across the Chinese border. These discussions also contemplated a coal load out facility directly located at the Ovoot Tolgoi mine site. The Company continues to carry out further studies with respect to these proposed facilities.

**Ovoot Tolgoi Underground Project**

The Ovoot Tolgoi Underground Project is contiguous to, and located directly, below the surface mine development. The entire extension of the coal at depth from 300 to 700 m that is designated for the underground development is located inside the existing Ovoot Tolgoi mining license.

In March 2008, TAG prepared a resource estimate for underground resources in the West Field. Estimated underground resources for the West Field are approximately 3.9 million tonnes of measured resources, 12.6 million tonnes of indicated resources and 36.7 million tonnes of inferred resources. The coal rank is volatile B to A bituminous based on ASTM D388 standards. Holes drilled in the 2007 exploration program were not included in the resource estimation. Details of the assumptions and parameters used to calculate these coal resources and coal quality estimates are set out in the Technical Report entitled "Underground Resources at Ovoot Tolgoi – West Field" dated March 28, 2008 and available at www.sedar.com.

The 2008 exploration program concentrated on the underground located in the West Field. This drilling was conducted to obtain additional information respecting the structure and quality of the deep underground coal mineralization. The drilling conducted in 2006 and 2007 has identified coking and semi-soft coal at depths of between 250 m and 600 m beneath the lower boundaries of the planned open pits at the South-East and West Fields. The 2008 program in the West Field has extended the depth of the potential mine to 700m. The No. 5 coal seam continues to be open at depth and along strike. The results from the 2008 drilling program will be incorporated into an updated resource report expected to be finished later in 2009.

**Soumber Project**

The Soumber Project is comprised of the N, O and E Fields. This coal field starts 16 km east of Ovoot Tolgoi and stretches for approximately 18 km to the east. The N, O and E fields are covered by Mineral Exploration License #9443, which also encompasses part of the Ovoot Tolgoi project. N field is located approximately 16 km east of the Ovoot Tolgoi South-East pit and 8 km west of O Field. E Field is located approximately 10 km west of O Field.

In 2005, coal occurrences were identified in the N and O fields. N Field coal occurrences have been identified approximately two km north of the east-west trending Nariin Sukhait thrust fault, the major structural feature of the Ovoot Tolgoi region. Further exploration drilling in 2006 suggests that these coal occurrences may in fact be one coal field. The 2007 exploration drilling provided additional structure and quality information, where significant intersections were encountered and potential exists for expanding known mineralization along strike and down dip.

In June 2008, the Company announced that it intersected significant thicknesses in near-surface seams of high-quality coking and thermal coal, including one intercept of 51.5 m. The 2008 drilling program was completed during the fourth quarter of 2008 and the results are expected to provide the basis for a resource estimate in 2009. The company has initiated mine planning and an application for a mining license, which will be submitted for development of this project. Environmental baseline studies have also been initiated.

**Tsagaan Tolgoi Project**

The Tsagaan Tolgoi coal field is located in south-central Mongolia. The property is located in the Omnogovi Aimag approximately 570 km south of Ulaanbaatar and 113 km southeast of the provincial capital of Dalanzadgad, and approximately 115 km west of Oyu Tolgoi.

A coal delineation program was first carried out in 2004, but no further work was conducted in 2005. Exploration programs were carried out during 2006 and 2007 to provide the basis for a resource estimate. In February 2008, Norwest estimated 23.4 million tonnes of measured resources, 13.0 million tonnes of indicated resources and 9.0 million tonnes of inferred resources. The coal is of volatile bituminous B to C in rank based on ASTM D 388 standards and is suitable for use as a thermal coal. The resources appear to be amenable to surface extraction down to a planned depth of 150 m. Details of the assumptions and parameters used to calculate these coal resources and coal quality estimates are set out in the Technical Report entitled "Coal Geology and Resources – Tsagaan Tolgoi Property" dated March 25, 2008 and available at www.sedar.com.

Effective August 12, 2009 the Mongolian government issued a mining license for the Tsagaan Tolgoi coal field. The Company is required to submit a Technical and Economic Study to the government agency in charge of mining within 60 days of the receipt of the mining license. A more detailed General Environmental Impact Assessment is underway and will be submitted following the approval of the Technical and Economic Study.
Any development of the field would be subject to whether Tsagaan Tolgoi is to be selected as a supplier of thermal coal for a power plant to be constructed to support Ivanhoe's Oyu Tolgoi copper and gold project. The timing of the continued development of the Oyu Tolgoi project is contingent upon a number of factors beyond the control of the Company and Ivanhoe, including the approval by the government of Mongolia of an investment agreement.

**Tavan Tolgoi Extension Project**

The Tavan Tolgoi Extension Project is composed of seven exploration licenses located east of Dalanzadgad, the provincial capital in the Omnogovi Aimag. These exploration licenses surround the third party-owned Tavan Tolgoi coal project. The Tavan Tolgoi coalfield was discovered in the 1950s by a joint Mongolian/Soviet team and is believed to be one of the largest undeveloped metallurgical coal deposits in the world.

A field reconnaissance program was carried out on the Tavan Tolgoi Extension licenses in 2006. The exploration area has been surveyed for copper and gold exploration using BHP Falcon aerial geophysics. The Company has obtained the aeromagnetic and aero gravity survey data and is using the results of the upcoming analysis of the Falcon data to help delineate potential coal targets. A significant exploration program was started in the third and fourth quarters of 2007, and the results are being used to delineate further potential coal targets. Exploration work on the extension continued in 2008 and is currently being updated.

## Properties in Indonesia

### Mamahak Coal Project

The Company holds its 85% interest in the Mamahak coal project through a joint venture and has commenced the development of green field's surface coal deposits in four concessions covering 22,968 ha in East Kalimantan, Indonesia, through its participation in the Mamahak coal project.

In September 2008, the Company increased its working interest in the original joint venture from 56% to 85%. Under the terms of the Joint Venture Earn-In Agreement ("JVA"), the Company has the right to increase its working interest position based on a predetermined pricing mechanism. The terms of the JVA allow the Company to increase its working interest to 100% in the project.

The 2008 drilling program identified quantities of high fluidity coking coal that appear to be amenable to surface mining.

In February 2009, SMG prepared a resource estimate for the E and SW resource blocks. SMG has estimated that the E resource block on the MCM concession contains 5.0 million tonnes of measured resources, 7.3 million tonnes of indicated resources and 2.7 million tonnes of inferred resources, while the SW resource block contains 2.6 million tonnes of inferred resources. The resource estimates have been calculated to Joint Ore Reserves Committee ("JORC") standards. The JORC resource quantities are equivalent to the resource quantities that would have been estimated using the CIM Definition Standards on Mineral Resources and Reserves mandated by National Instrument 43-101. Details of the assumptions and parameters used to calculate these coal resources and coal quality estimates are set out in the Technical Report entitled "Mamahak Coal Project" dated March 26, 2009 and available at www.sedar.com.

Further drilling is ongoing and development drilling activity is being carried out to the north of the SW mine area in the W and N resource block areas of the MCM concession. It is expected that the data obtained will provide the basis for further resource estimates. The Company has also continued regional mapping and assessment of up to five new concessions that are nearby the MCM concession area.

Required permit applications for mining, coal transportation and a barge load-out facility for the area have been filed. In early January 2009, a permit was issued, which allows the Company to commence surface coal mining at the SW deposit on the MCM concession. The Company engaged two smaller mining contractors, who have significant experience in operations similar to Mamahak, to conduct mine development. In April 2009, initial development work was started with the removal of waste rock, extraction and roadwork. A site office, accommodation camp and a satellite communication system have been mobilized for the project. An administrative project office has been established at the port village of Melak on the Mahakam River approximately 90 km from the site.

The 34km coal haul from the SW deposit to the barge port on the Mahakam River has been completed and commissioned. The installation of a river barge loading terminal which is located at Long Habung on the Mahakam River has also been completed, as well as installation and commissioning of truck weigh scales, coal crushing equipment and a mine site coal analysis laboratory.

In May 2009, the Company signed a coal marketing agreement with Glencore. Under the terms of the agreement, Glencore will provide the Company with coking coal marketing expertise and river barging/vessel loading logistical services. With the completion of the coal marketing agreement the

Company is planning to ship an initial 30,000 tonne test cargo from the Mamahak coal project to a potential Asian customer in the third quarter.

The Indonesian Parliament passed a new law on mineral and coal mining, known as Minerba, at the end of 2008, which was signed by the President of the Republic of Indonesia and became effective on January 12, 2009. The Company is currently reviewing the provisions in Minerba and waiting for the Indonesian Government to issue the required implementing regulations. The new law seeks to clarify the issues on the role of government in the mining licensing process, introduce two new types of mining concessions under a new licensing system, include provisions regarding the use of, and types of activities which may be conducted by mining services contractors and introduce domestic market obligations. Many of the details surrounding the implementation of the new rules under Minerba are not yet clear and are to be provided for in a series of Government implementing regulations. The Indonesian Government is required to issue those implementing regulations under Minerba before January 12, 2010.

**Metals Division Profile and Discontinued Operations**

On December 31, 2008, the Company announced the sale of the Metals Division to Ivanhoe for $3 million and other non-cash consideration. The Metals Division consisted of a series of base and precious metal exploration properties in Mongolia and Indonesia, related assets, employees and contracts. As part of the sale transaction, the Company obtained a credit facility from Ivanhoe, providing for loan advances from Ivanhoe up to $30 million. The credit facility is for a one year term with a one year discretionary extension. The credit facility is unsecured and carries an interest rate equal to LIBOR plus 750 basis points.

The Company also received a 1% net returns royalty in certain mineral projects in Indonesia, and retained the rights to the Kharmagtai and Chandman Uul properties in Mongolia.

The transaction was completed on February 2, 2009 following receipt of regulatory approval.

## SELECTED QUARTERLY DATA

($ in thousands, except per share information)

| | 2009 | | 2008 | | | | 2007 | |
|---|---|---|---|---|---|---|---|---|
| **QUARTER ENDED** | **30-Jun** | 31-Mar | 31-Dec | 30-Sep | 30-Jun | 31-Mar | 31-Dec | 30-Sep |
| Revenue | **$ 10,667** | $ 3,540 | $ 3,126 | $ - | $ - | $ - | $ - | $ - |
| Exploration expenses | **4,641** | 4,130 | 8,104 | 11,361 | 10,363 | 6,375 | 5,992 | 5,274 |
| Loss from continuing operations | **7,910** | 9,960 | 14,457 | 21,110 | 11,189 | 14,909 | 42,500 | 10,836 |
| Loss from discontinued operations | **-** | - | 2,549 | 1,667 | 2,392 | 1,302 | - | - |
| Net loss | **7,910** | 9,960 | 17,006 | 22,777 | 13,581 | 16,211 | 42,500 | 10,836 |
| Net loss per share | **(0.06)** | (0.07) | (0.13) | (0.17) | (0.11) | (0.19) | (0.57) | (0.15) |

**<u>Selected Quarterly Information</u>**

The changes in comparative results of operations on a quarter over quarter basis are due primarily to significant fluctuations in the following areas: revenue, exploration expenses, stock-based compensation charges, foreign exchange gains and losses, interest expense, interest accretion on line of credit facility and fair value of embedded derivative on debt. These latter two items are described in note 3 and 15 to the Consolidated Interim Financial Statements.

Revenue from coal sales, which began at the end of September 2008, increased during the quarter ended December 31, 2008. For the 3 months ended June 30, 2009, revenue increased compared to the 3 months ended March 31, 2009. Major factors contributing to the increase were the mobilization by customers of larger truck fleets and enhancements at the border crossing. Exploration expenses will vary from quarter to quarter depending on the number of projects and the related seasonality of the exploration programs. Exploration costs for the Metals Division are classified as a loss from discontinued operations and were incurred for exploration projects in Mongolia and Indonesia. Coal expenditures in Mongolia were initially incurred during the quarter ended June 30, 2007. Expenditures on the Indonesian Coal Division began in the first quarter of 2008.

## RESULTS OF OPERATIONS

| | Three Months Ended | | | Six Months Ended | |
|---|---|---|---|---|---|
| | **June 30, 2009** | March 31, 2009 | June 30, 2008 | **June 30, 2009** | June 30, 2008 |
| **Volumes, Prices and Costs** | | | | | |
| Coal production *(millions of tonnes)* | **-** | 0.16 | - | **0.16** | - |
| Coal sales *(millions of tonnes)* | **0.38** | 0.13 | - | **0.51** | - |
| Average sales price *(per tonne)* | **$ 29.71** | $ 29.26 | - | **$ 29.60** | - |
| Total cash costs of product sold *(per tonne)* | **$ 18.13** | $ 18.51 | - | **$ 18.23** | - |
| Direct cash costs of product sold *(per tonne)* | **$ 16.64** | $ 14.29 | - | **$ 16.05** | - |
| **Operating Statistics** | | | | | |
| Total waste material moved *(millions of bank cubic metres)* | **-** | 0.34 | - | **0.34** | - |
| Strip ratio *(bank cubic metres of waste rock per tonne of clean coal produced)* | **-** | 2.19 | - | **2.19** | - |
| **Operating Results *(thousands of dollars)*** | | | | | |
| Revenue | **$ 10,667** | $ 3,540 | $ - | **$ 14,207** | $ - |
| Cost of Sales | **(9,139)** | (3,213) | - | **(12,352)** | - |
| Income from mine operations | **1,528** | 327 | - | **1,855** | - |
| Adminstration expenses | **(4,444)** | (6,105) | (1,406) | **(10,549)** | (2,512) |
| Evaluation and exploration expenses | **(4,641)** | (4,130) | (10,363) | **(8,771)** | (16,738) |
| Operating loss from continuing operations | **$ (7,557)** | $ (9,908) | $ (11,769) | **$ (17,465)** | $ (19,250) |

### Three Months Ended June 30, 2009 and 2008

The Company incurred an operating loss from continuing operations for the three months ended June 30, 2009 of $7.6 million compared to $11.8 million for the same period in 2008. This change is due to the factors discussed below.

Revenue, net of royalty expense and cost of sales relate to the Company's operations in Mongolia. Through early 2009 shipments across the border were limited and as a result the Company initiated a production curtailment program in January 2009. This was followed by a full mine shut down on February 24, 2009, except for coal loading of customer trucks from coal stockpiles.

In the second quarter of 2009, the Company shipped approximately 384,000 tonnes of coal at an average realized selling price of approximately $30 per tonne. This compares to 127,000 tonnes of coal shipped in the first quarter at an average realized selling price of $29 per tonne.

Shipments in the quarter improved due to improved border access. In April and May 2009 shipments totaled approximately 152,000 tonnes. In June 2009, the border started operating at 11 hours per day, six days per week and June shipments were approximately 232,000 tonnes.

Cost of sales was $9.1 million in the current quarter, which comprise the cost of the product sold, mine administration costs, equipment depreciation, and depletion of stripping costs. Total cash costs per tonne of product sold in the second quarter of 2009 were $18.13 compared to $18.51 for the first quarter of 2009. The decrease is due primarily to increased sales in the quarter. The direct cash costs however, increased in the quarter as operational costs were expensed due to the full mine shut down at the end of February 2009. The current direct cash costs included in inventory at June 30, 2009 are $10.60 tonne.

Exploration expenses for the three months ended June 30, 2009 were lower than the quarter ended June 30, 2008. In the three months ended June 30, 2009 there were less drilling expenditures as non-prospective licenses were dropped and no further exploration work was conducted on these licences. Exploration expense in 2009 also includes a recovery of $825,000 for the sale of licenses in Mongolia. As well prior to the commencement of sales in late September 2008, certain operational costs were treated as exploration expense.

Administration expenses for the quarter ended June 30, 2009 were $4.4 million compared to $1.4 million for the quarter ended June 30, 2008. Administration expenses for the quarter ended June 30, 2009 include approximately $2.6 million of stock based compensation compared to approximately $688,000 for the same period last year. Other amounts that are included in the quarter ended June 30, 2009 that are not comparable to the 2008 quarter are listing fees, professional fees related to the various technical reports for the Mongolia project, and a foreign exchange loss compared to a foreign exchange gain for the quarter ended June 30, 2008.

The administration expenses consist of the following major categories broken down for comparative purposes (see Note 8 of the Consolidated Interim Financial Statements).

Legal fees for the quarter ended June 30, 2009 were consistent with the quarter ended June 30, 2008. Legal fees include costs associated with the Company's regulatory affairs including expenses associated with corporate governance, filing, registration and disclosure.

Corporate administration fees decreased in the three months ended June 30, 2009 compared to the same period in 2008. The decrease relates to reduced investor relations and office and administration support costs. Certain of the Company's administrative staff and office facilities are provided by Global Mining Management Ltd (see 'Related Party Transactions') on a cost recovery basis. Accordingly, quarterly fluctuations in the costs of administrative and personnel costs can be expected commensurate with increases or decreases in quarterly corporate activity and the level of personnel employed.

Professional fees have increased for the three months ended June 30, 2009 as compared to the same period in 2008. Quarterly charges include the cost of quarterly reviews, internal computer systems training and planning, and accruals for the year end audit of the Company's financial statements. The increase in the current quarter relates predominantly to costs related to the various technical reports for the Mongolia project.

Salaries and benefits, excluding stock based compensation costs, decreased in the three months ended June 30, 2009 to $551,000 as compared to $684,000 for the three months ended June 30, 2008. Salary and benefits in the quarter ended June 30, 2008 included bonuses.

The foreign exchange losses/(gains) are primarily the result of changes of the U.S. to Canadian dollar and the U.S. to Mongolian Tugrik exchange rates during the period.

Listing fees consist of legal, accounting and professional fees incurred for a secondary listing on an Asian stock exchange. Normally the Company would treat the charges as share issue costs upon a successful equity fundraising and had capitalized the listing fees to June 30, 2008. However, uncertainty in the timing of a possible equity financing led to a decision to expense these costs in the third quarter of 2008. The Company is continuing with the secondary listing application.

**Six Months Ended June 30, 2009 and 2008**

The Company incurred an operating loss from continuing operations for the six months ended June 30, 2009 of $17.5 million compared to $19.3 million for the same period in 2008. This change is due to the factors discussed below.

In the six month period ended June 30, 3009, the Company shipped approximately 512,000 tonnes of coal at an average realized selling price of approximately $30 per tonne.

Cost of sales was $12.4 million in the six months ended June 30, 2009, which comprise the cost of the product sold, mine administration costs, equipment depreciation, and depletion of stripping costs. Total cash costs per tonne of product sold in the six months ended June 30, 2009 were $18.23.

Exploration expenses for the six months ended June 30, 2009 were $8.8 million as compared to $16.7 million for the same period in 2008. In 2008, exploration expenditures in Mongolia were higher as the Coal Division assembled equipment, hired additional personnel and began pre-development activities at the Ovoot Tolgoi mine site. Throughout 2008, the Mongolia coal exploration program concentrated on drilling in the West Field. The Coal Division continued its exploration activities in Indonesia throughout the six months ended June 30, 2009.

Administration expenses were $10.5 million for the six months ended June 30, 2009 as compared to $2.5 million for the six months ended June 30, 2008. Stock based compensation expense allocated to administration expenses was $5.8 million for the six months ended June 30, 2009 and $1.3 million for the same period in 2008. Other amounts that are included in the six months ended June 30, 2009 that account for the increase compared to the 2008 period are listing fees, professional fees related to the various technical reports for the Mongolia project, a corporate consulting contract and a foreign exchange loss compared to a foreign exchange gain for the six months ended June 30, 2008.

The administration expenses consist of the following major categories broken down for comparative purposes (see Note 8 of the Consolidated Interim Financial Statements).

Legal fees for the six months ended June 30, 2009 and June 30, 2008 were for costs associated with the Company's regulatory affairs including expenses associated with corporate governance, filing, registration and disclosure.

Corporate administration fees increased in the six months ended June 30, 2009 compared to the same period in 2008. The increase relates to higher insurance costs and filing fees.

Professional fees have increased for the six months ended June 30, 2009 as compared to the same period in 2008. Included in professional fees are the cost of quarterly reviews, internal computer systems training and planning, and accruals for the year end audit of the Company's financial statements. The increase relates predominantly to increased audit fees, increased internal control costs, costs related to the various technical reports for the Mongolia project and a corporate consulting contract for the Mongolian operations.

Salaries and benefits, excluding stock based compensation costs in the six months ended June 30, 2009 was $972,000 which was consistent with $977,000 for the six months ended June 30, 2008. Bonuses paid in 2008 are offset by higher director fees in the 6 months ended June 30, 2009.

A foreign exchange loss of $992,000 was recorded for the six months ended June 30, 2009 as compared to a gain of $1.2 million for the six months ended June 30, 2008. The foreign exchange losses/ (gains)

are primarily the result of changes of the U.S. to Canadian dollar and the U.S. to Mongolian Tugrik exchange rates during the period.

Listing fees consist of legal, accounting and professional fees incurred for a secondary listing on an Asian stock exchange. Normally the Company would treat the charges as share issue costs upon a successful equity fundraising and had capitalized the listing fees to June 30, 2008. However, uncertainty in the timing of a possible equity financing led to a decision to expense these costs in the third quarter of 2008. The Company is continuing with the secondary listing application.

## EXPLORATION COSTS AND DISCONTINUED OPERATIONS BY DIVISION

($ in thousands)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2009** | 2008 | **2009** | 2008 |
| Mongolian Coal Division | **$ 1,743** | $ 9,130 | **$ 2,511** | $ 13,023 |
| Indonesian Coal Division | **2,898** | 1,233 | **6,260** | 3,715 |
| Total Exploration | **$ 4,641** | $ 10,363 | **$ 8,771** | $ 16,738 |

### Coal Division

The total coal exploration expenditures in the three months ended June 30, 2009 were $4.6 million compared to $10.4 million for the same period in 2008. For the six months ended June 30, 2009 coal exploration expenditures were $8.8 million as compared to $16.7 million for the six months ended June 30, 2008.

Exploration costs are charged to operations until such time as it has been determined that a property has economically recoverable reserves, in which case the costs incurred to develop a property are capitalized.

The costs of pre-development, overburden removal and stripping activities, which are incurred in the pre-production stage are expensed as incurred. The Company commenced mining operations in Mongolia on April 2, 2008, and costs incurred for site development prior to the production phase were expensed.

The Mongolian Coal Division started exploration and development subsequent to the completion of the coal transaction at the end of May 2007. Expenditures in the first six month of 2008 were incurred as the Coal Division assembled equipment, hired additional personnel and began pre-development activities at the Ovoot Tolgoi mine site. Pre-development of the Ovoot Tolgoi open pit mine site included road construction, site clearing, drainage control and topsoil removal. The exploration expenditures also included consulting-geological, drilling, license fees, office and salary and benefits.

Exploration expenditures in Mongolia were approximately $1.7 million for the three months ended June 30, 2009 compared to $9.1 million in 2008. Prior to the commencement of sales in late September 2008, certain operational costs were treated as exploration expense. For the three months ended June 30, 2009, the Mongolia exploration expenditures included consulting-geological, drilling, license fees, office, salary and benefits and a recovery on licenses sold in June 2009. Exploration expenditures will vary from quarter to quarter and are also related to the seasonality of the exploration programs.

In Indonesia, exploration expenditures were $2.9 million for the three months ended June 30, 2009 compared to $1.2 million in 2008. The Company began its exploration activities in Indonesia in early 2008. The 2008 drilling program identified quantities of coking coal that appear to be amenable to surface mining. Further drilling is ongoing and development drilling activity is being carried out to the north of the SW mine area in the W and N resource block areas of the MCM concession. Exploration expenditures increased in 2009 as the company prepares for production.

In January 2009, a permit was issued which will allow the Company to commence surface coal mining at the SW deposit on the MCM concession. In April 2009, initial development work was started with the removal of waste rock, extraction and roadwork. In the three months ended June 30, 2009, deferred stripping costs were capitalized as Indonesia entered the production stage ($1.7 million).

**Metals Division – Discontinued Operations**

The Company sold the Metals Division to Ivanhoe in December 2008. The Metals Division consisted of a series of base and precious metal exploration properties in Mongolia and Indonesia. In 2008, the proceeds of $3 million were classified as a deposit received for the sale of the division. The gain on sale of the Metals Division is $2.6 million and is classified in the consolidated statement of changes in equity.

In 2008, the sale of the Metals Division was disclosed as a discontinued operation and its financial results were presented as separate items in the consolidated statement of financial position and statements of comprehensive income and cash flows.

During the three and six months ended June 30, 2008, exploration expenses were $2.4 million and $3.7 million respectively. The majority of the expenses incurred in Mongolia and Indonesia were related to ongoing license fees, drilling, and salaries.

The exploration expenditures of $2.4 million for the quarter ended June 30, 2008 and $3.7 million for the six months ended June 30, 2008 have been classified as a loss from discontinued operations. The basic and diluted loss per share from discontinued operations is $0.02 for the quarter ended June 30, 2008 and $0.03 for the six months ended June 30, 2008.

## OTHER INCOME/EXPENSE

($ in thousands)

| | **Three Months Ended June 30** | | **Six Months Ended June 30,** | |
|---|---|---|---|---|
| | **2009** | 2008 | **2009** | 2008 |
| Fair value change on embedded derivative | **$ -** | $ - | **$ -** | $ (7,223) |
| Interest accretion on line of credit facilities | **-** | - | **-** | (598) |
| Interest expense | **(345)** | - | **(398)** | (134) |
| Accretion expense | **(11)** | - | **(20)** | - |
| Interest income | **3** | 580 | **12** | 1,108 |
| | **$ (353)** | $ 580 | **$ (406)** | $ (6,847) |

On April 26, 2006, in conjunction with the coal transaction, the Company entered into a line of credit facility (the “First Funding Agreement”) with Ivanhoe whereby Ivanhoe agreed to make available to the Company an unsecured line of credit of up to $10 million which was extended to a maximum of $15 million on June 6, 2007. Attached to the First Funding Agreement was a conversion option which became effective upon the completion of the coal transaction. On January 23, 2008, concurrent with the closing of equity private placements and at the Company’s request, Ivanhoe converted the then principal balance of $29,982,631 into 14,709,701 common shares of the Company. As a result of this conversion the amount due under line of credit facility was eliminated.

Under IFRS, the conversion feature is considered an embedded derivative liability that must be recorded at its fair value upon initial measurement and revalued at each subsequent reporting period.

The difference between the debt host component and the principal amount of the loan outstanding is accreted to income over the remaining term of the debt. (Please refer to Note 15.4 of the Consolidated Interim Financial Statements for further details).

Interest expense was higher in the quarter end June 30, 2009 and the six months ended June 30, 2009 compared to the same periods in 2008. This is related to advances on the line of credit to fund operations. In January 2008, with the completion of the additional equity private placements, the First Funding Agreement line of credit facility and the Second Funding Agreement were terminated.

In 2009, as part of the sale of the Metals Division, the Company obtained a $30 million working capital credit facility from Ivanhoe. The credit facility is for a one year term with a one year discretionary extension. The credit facility is unsecured and carries an interest rate equal to LIBOR plus 750 basis points. The Company has received advances of $24 million against the line of credit facility in the first six months of 2009.

The Company recognizes asset retirement obligations in the period in which they are incurred. The liability component is measured at fair value and is adjusted to its present value as accretion expense is recorded.

Interest income was higher in 2008, due to higher cash balances which relate to the completion of the equity financings in early 2008. Lower interest income during 2009 reflects lower average cash balances during this period.

## LIQUIDITY AND CAPITAL RESOURCES

### Cash Flow Highlights

($ in thousands)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2009** | 2008 | **2009** | 2008 |
| Cash used in operating activities | **$ (6,683)** | $ (15,776) | **$ (16,097)** | $ (27,141) |
| Cash used in investing activities | **(10,047)** | (25,542) | **(15,583)** | (38,312) |
| Cash generated by financing activities | **16,158** | 26,031 | **24,380** | 133,598 |
| Effect of foreign exchange rate changes on cash | **(27)** | 902 | **(11)** | 1,394 |
| (Decrease) increase in cash for the period | **(599)** | (14,385) | **(7,311)** | 69,539 |
| Cash balance, beginning of period | **3,405** | 85,318 | **10,117** | 1,394 |
| Cash balance, end of period | **$ 2,806** | **$ 70,933** | **$ 2,806** | **$ 70,933** |

### General market conditions

In 2008 and 2009 market events and conditions, including the disruptions in the international credit markets and other financial systems and deterioration of global economic conditions, caused significant volatility in commodity prices. Given the high volatility, it is difficult to forecast the price of and related demand for the Company's coal products. Credit market conditions have also increased the cost of obtaining capital and limited availability of funds. Management continues to monitor external conditions and their impact on the Company's business plans for the upcoming year.

### Cash used in operating activities

At June 30, 2009 the Company had cash resources of $2.8 million compared to cash resources of $10.1 million at December 31, 2008.

Cash used in continuing operations was $6.7 million for the three months ended June 30, 2009 compared to $13.4 million for the same period in 2008. For the six months ended June 30, 2009 cash used in continuing operations was $16.1 compared to $24.3 million for the six months ended June 30, 2008. Cash used in discontinued operations for the three and six month periods ended June 30, 2008 was $2.4 million and $2.8 million, respectively. The Metals Division was sold in December 2008, which will have no impact on discontinued operations disclosure for periods in 2009.

In the three and six month period ended June 30, 2009, the Company incurred a net loss from continuing operations of $7.9 million and $17.9 million, respectively, compared to a net loss from continuing operations for the three and six months ended June 30, 2008 of $11.2 million and $26.1 million respectively. Continuation of the Company's build out of the Ovoot Tolgoi mining operation, higher finance costs and evaluation and exploration costs contributed to the higher losses in 2008. In 2009, the Company recorded revenue of $10.7 million for the three months ended June 30, 2009 and $14.2 million for the six months ended June 30, 2009. With the increased activities at the Ovoot Tolgoi site and the operations in Mongolia, accounts receivable, prepaid expenses, and accounts payable increased during six months ended 2009.

In 2008, foreign exchange gains were primarily reflective of the larger US and Canadian cash balances due to the completion of the private equity placements and the related changes in the value of the Canadian dollar versus its US counterpart. The foreign exchange loss, in 2009, is primarily reflective of the change in the value of the Mongolian Tugrik versus the US dollar.

Accounts receivable include funds due from government taxation authorities (Goods and Services Tax or Value Added Tax). Verification of the collectability of the funds from government taxation authorities was conducted in the fourth quarter of 2008 and early 2009 and the Company anticipates full recoverability of amounts due on account. Payment of accounts receivable due from government taxation authorities in Mongolia could be delayed throughout 2009, and may be used to offset future income taxes payable on account.

The Company is also closely monitoring collectability of outstanding accounts receivable for current coal sales. Although all accounts are currently in order, unfavorable market conditions may have an impact on future collectability.

Prepaid balances have increased during 2009. The increase relates to the timing of prepayments for Mongolian exploration licenses, supplies, insurance, and additional security deposits in Indonesia.

Coal and supplies inventory have decreased to $11.4 million at June 30, 2009 from $13.7 million at the year ended December 31, 2008. Coal and supplies inventory is valued at the lower of cost and net realizable value. Coal inventory cost of $10.8 million includes direct and indirect labour, operating materials and supplies, transportation costs and an appropriate portion of fixed and variable overhead expenses including depreciation and depletion. Supplies inventory consists of consumable parts and supplies.

The Company had a stockpile of approximately 688,000 tonnes of coal inventory at June 30, 2009.

Accounts payable have increased in the six months ended June 30, 2009 due to increased activity in Indonesia.

**Cash used for investing activities**

Cash used for investing activities was $10.0 million for the three months ended June 30, 2009 compared to $25.5 million for the same period in 2008. For the six months ended June 30, 2009 cash used for investing activities was $15.6 million compared to $38.3 million for the six months ended June 30, 2008.

The Company's investment in property, plant and equipment was higher during 2008. Deposits for further mining equipment and maintenance facilities are included as plant and equipment. In the three months ended June 30, 2008 deferred stripping costs in Mongolia were also included. The Company incurred expenditures in 2009 for mobile and mining equipment in Mongolia and construction projects and deferred stripping in Indonesia.

Interest income will increase or decrease in a quarter depending on the cash position. Interest was higher in 2008 due to higher cash balances which related directly to the completion of the equity financings.

**Cash provided by financing activities**

During the six months ended June 30, 2008, the Company completed a series of equity financing transactions and received proceeds from the exercise of stock options. The total proceeds net of issue costs were $26.0 million for the three months ended June 30, 2008 and $139.7 million for the six months ended June 30, 2008, compared to proceeds received for the exercise of stock options in the three and six months ended June 30, 2009 of $158,000 and $380,000, respectively.

The proceeds from the equity financings in 2008 were used for the initial development of the open-pit coal mine at the Company's Ovoot Tolgoi project, and for additional drilling and engineering focused on the Ovoot Tolgoi site and development of the Indonesia coal project. Proceeds have also been used for investigating new projects, equipment expenditures and for general corporate and administrative purposes. The proceeds were also used to repay amounts advanced under the line of credit facility obtained from Ivanhoe in October 2007.

On December 31, 2008, the Company announced the sale of its Metal Division to Ivanhoe for $3 million and other non-cash consideration. As part of the sale transaction, the Company obtained a $30 million credit facility from Ivanhoe. The credit facility is for a one year term with a one year discretionary extension. The credit facility is unsecured and carries an interest rate equal to LIBOR plus 750 basis points. For the six months ended June 30, 2009, the Company received advances of $24 million against the line of credit facility.

**Liquidity, Financing and Working Capital Resources**

The Company is an integrated coal exploration, development and production company. The Company's ability to continue as a going concern is dependent upon establishing profitable operations, the confirmation of economically recoverable reserves, and the ability of the Company to obtain further financing to develop properties.

The Company has been reviewing its detailed revenue and expenditure plans, both discretionary and non-discretionary, for 2009 and has identified the need for further financing to enhance its working capital resources. The Company is prioritizing its budgeted expenditures with a current emphasis on production and near term cash flow.

As part of the sale of the Metals Division to Ivanhoe in December 2008, the Company obtained a $30 million credit facility from Ivanhoe. The credit facility is for a one year term with a one year discretionary extension. The credit facility is unsecured and carries an interest rate equal to LIBOR plus 750 basis points.

In July 2009, the Company and Ivanhoe agreed to increase the existing working capital credit facility from $30 million to $60 million. The amended credit facility will mature on December 31, 2010, is unsecured and bears interest at LIBOR plus 750 basis points. The amended facility also requires repayment in the event that the Company acquires additional financing from a third party source and provides for an extension fee of $1.5 million payable in the event any portion of the facility is outstanding past March 31, 2010. This additional $30 million working capital facility will allow the Company to continue to fund its expansion plans and current operations in Mongolia and Indonesia.

The Company will be incurring expenditures for the exploration, development, and production of its current coal assets, and to the extent that available financial resources permit, will incur expenditures for the acquisition of further coal assets. Revenue from current operations will not be sufficient to meet current expenditure levels.

Cash generated from operations may increase in 2009, but it may not be sufficient to meet all expenditure levels. Management believes that additional debt or equity financing, beyond the current credit facility with Ivanhoe, is available but no additional source of funding has yet been identified. The Company will be reviewing all discretionary and non-discretionary spending, which will include a review of future project costs and capital commitments.

## RELATED PARTY TRANSACTIONS

The Company is a party to a shareholders' cost-sharing agreement with certain other public and private companies, including Ivanhoe (the "Other Companies") pursuant to which the Company and the Other Companies are equal shareholders in Global Mining Management Ltd ("GMM") and, through GMM, share office space, furnishings and equipment and communications facilities (on a cost recovery basis) and the employment, on a part-time basis, of various administrative, office and management personnel in Vancouver, British Columbia. Costs of the shared office facilities and the shared part-time employees and service providers are recovered from the Company proportionate to the time spent by the shared part-time employees and service providers on matters pertaining to the Company. Certain of the directors and officers of the Company are also officers and directors of GMM. The Company has utilized the services of the GMM staff and office since September 1, 2003 and has incurred costs of $883,000 and $1.5 million for the six months ended June 30, 2009 and 2008, respectively.

On December 31, 2008, the Company announced the sale of the Metals Division to Ivanhoe for $3 million and other non-cash consideration. The Metals Division consisted of a series of base and precious metal exploration properties in Mongolia and Indonesia, related assets, employees and contracts. As part of the sale transaction, the Company obtained a credit facility from Ivanhoe, which allows SouthGobi to receive loan advances from Ivanhoe to an aggregate maximum of $30 million. The credit facility is for a one year term with a one year discretionary extension. The credit facility is unsecured and carries an interest rate equal to LIBOR plus 750 basis points.

In July 2009, the Company and Ivanhoe agreed to increase the existing working capital credit facility from $30 million to $60 million. The amended credit facility will mature on December 31, 2010, is unsecured and bears interest at LIBOR plus 750 basis points. The amended facility also requires repayment in the event that the Company acquires additional financing from a third party source and provides for an extension fee of $1.5 million payable in the event any portion of the facility is outstanding past March 31, 2010. This additional $30 million working capital facility will allow the Company to continue to fund its expansion plans and current operations in Mongolia and Indonesia.

## OUTSTANDING SHARE DATA

The Company is authorized to issue an unlimited number of common shares without par value and an unlimited number of preferred shares without par value. As at July 28, 2009: 133,367,382 common shares were issued and outstanding. There are also incentive stock options outstanding that are exercisable to acquire 7,577,285 unissued common shares. On a diluted basis, 140,944,667 common shares were outstanding. There are no preferred shares outstanding.

Ivanhoe, directly and indirectly, currently owns 106,607,155 common shares representing approximately 80% of the issued and outstanding common shares of SouthGobi.

## INTERNAL CONTROLS OVER FINANCIAL REPORTING

There has been no change in the Company's internal controls over financial reporting that occurred during the most recently completed quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

## RISK FACTORS

The business of mineral exploration and extraction involves a high degree of risk. Few properties that are explored are ultimately developed into production.

Material risks and uncertainties affecting SouthGobi, their potential impact and the Company's principal risk management strategies are substantially unchanged from those disclosed in the Company's MD&A for the year ended December 31, 2008, which is available at www.sedar.com.

## OUTLOOK

In 2008 market events and conditions, including the disruptions in the international credit markets and other financial systems and the deterioration of global economic conditions, caused significant volatility in commodity prices. Throughout 2009 coal prices are expected to remain volatile, but we are encouraged by long-term fundamentals for the Company's core commodity.

We believe that demand for commodities will increase as the current economic crisis passes. General economic conditions are showing signs of improvement. It is still difficult to forecast commodity prices and customer demand for our products; however our sales and marketing efforts in the most recent quarter are providing positive results. The Company is continuing to pursue new customers, and maintain strong relations with its current customer base.

The Company's properties in Mongolia and Indonesia are both well located in close proximity to China and other major industrializing economies in Asia. Furthermore, our near-term production is in high quality bituminous thermal and coking coals, which we anticipate will remain attractive premium products.

### Mongolia

Revenue was $10.7 million for the three months ended June 30 2009 compared to $3.5 million for the three months ended March 31, 2009. The Company will continue to focus on generating higher sales volume throughout the remainder of 2009.

In March 2009 the border started opening more reliably for seven days per week on an eight hour per day basis. In April and May 2009 shipments totaled approximately 152,000 tonnes. In June, the border started operating at 11 hours per day, six days per week. Total shipments in June were approximately 232,000 tonnes, a new record for the Company.

The Company is engaged in ongoing discussions with the Mongolian Government with the objective of establishing a border crossing at the Ceke border point that will be open for a full 24 hours per day, 365 days per year. This should increase daily distribution of Ovoot Tolgoi coal to our customers in China.

With increasing sales and reductions in its coal inventory the Company has initiated full mining operations effective July 1, 2009.

In the quarter ended June 30, 2009 existing Chinese customers concluded new sales contracts with the Company to provide additional coal. The Company has also identified a number of potential new customers in Western Inner Mongolia and other parts of China. These potential new customers include end users, distributors, steel mills, power plants and industrial consumers.

SouthGobi has appointed a major international engineering firm, Norwest, to complete a new technical report for the Ovoot Tolgoi project incorporating outstanding data obtained from drilling to the end of 2008. The Company believes the new report, which is expected to be completed later in 2009, will more fully demonstrate the potential of the Ovoot Tolgoi coal deposit.

**Indonesia**

In January 2009, a permit was issued, which allowed the Company to commence surface coal mining at the SW resource block on the MCM concession.

In May 2009, the Company completed an agreement with Glencore to provide coking coal marketing expertise and river barging/vessel loading logistical services for MCM.

The Company plans to ship a test cargo of approximately 30,000 tonnes to a customer in the third quarter.

**Overview and Objectives**

As we look forward through the remainder of 2009, we are encouraged by the positive developments in each of our business units in Indonesia and Mongolia. We are making progress with our sales and marketing efforts, and intend to manage production levels to meet anticipated demand for our products.

Our objectives for 2009 have not changed:

i. continue evolving into a fully-fledged producer through the advancement of our key projects and, in particular, through expanded sales and production at Ovoot Tolgoi and commencement of trial shipments at Mamahak;
ii. utilize our knowledge of our properties in Mongolia and Indonesia to deliver continued exploration success with the aim of substantially increasing the Company's coal resource base;
iii. maximize the market pricing of our coal through further development of relationships with customers that recognize the value of its premium specification;
iv. remain focused on efficiency and prudent financial management; and
v. access appropriate sources of financing for our development and expansion plans.

Although coal prices and general economic conditions remain volatile, our operations have performed well, even in these challenging times.

August 5, 2009