



**SouthGobi Energy Resources Ltd.**  
**CONSOLIDATED FINANCIAL STATEMENTS**  
December 31, 2009  
(Stated in U.S. dollars)

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## Auditors' Report

To the Shareholders of  
SouthGobi Energy Resources Ltd.

We have audited the consolidated statements of financial position of SouthGobi Energy Resources Ltd. as at December 31, 2009 and 2008 and the consolidated statements of comprehensive income, changes in equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

*Deloitte & Touche LLP*

Chartered Accountants  
March 22, 2010

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# SOUTHGOBI ENERGY RESOURCES LTD.

## Consolidated Statement of Comprehensive Income

(expressed in thousands of U.S. Dollars, except for share and per share amounts)

	Notes	Year ended December 31, 2009	Year ended December 31, 2008
			(restated)
<b>CONTINUING OPERATIONS</b>			
Revenue		\$ 36,038	\$ 3,126
Cost of sales	7	(29,425)	(2,177)
<b>Income from mine operations</b>		<b>6,613</b>	<b>949</b>
Administration expenses	8	(24,535)	(20,358)
Evaluation and exploration expenses	9	(5,399)	(26,445)
<b>Operating loss from continuing operations</b>		<b>(23,321)</b>	<b>(45,854)</b>
Finance costs	10	(62,911)	(7,989)
Interest income		77	1,868
<b>Loss before tax</b>		<b>(86,155)</b>	<b>(51,975)</b>
Current income tax expense	11	(509)	-
Deferred income tax recovery	11	6,947	-
<b>Loss from continuing operations</b>		<b>(79,717)</b>	<b>(51,975)</b>
Loss from discontinued operations	6	(31,088)	(17,601)
<b>Net loss and comprehensive loss attributable to equity holders of the Company</b>		<b>\$ (110,805)</b>	<b>\$ (69,576)</b>
<b>BASIC AND DILUTED LOSS PER SHARE FROM:</b>			
Continuing operations	12	(0.60)	(0.40)
Discontinued operations	12	(0.23)	(0.14)
<b>Continuing and discontinued operations</b>		<b>(0.83)</b>	<b>(0.54)</b>
Weighted average number of basic and diluted shares outstanding ('000s)	12	133,499	128,354

The accompanying notes are an integral part of these Consolidated Financial Statements.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Consolidated Statement of Financial Position

*(expressed in thousands of U.S. Dollars)*

		As at December 31, 2009	As at December 31, 2008 (restated)      2007 (restated)	
	Notes			
<b>ASSETS</b>				
<b>Current assets</b>				
Cash and cash equivalents	13	\$ 357,342	\$ 10,117	\$ 1,394
Trade and other receivables	14	12,328	7,290	760
Short term investments	16	14,999	-	-
Inventories	17	16,384	13,677	-
Prepaid expenses and deposits	18	8,119	2,578	1,890
		<b>409,172</b>	<b>33,662</b>	<b>4,044</b>
Assets classified as held for sale	6	-	638	-
<b>Total current assets</b>		<b>409,172</b>	<b>34,300</b>	<b>4,044</b>
<b>Non-current assets</b>				
Property, plant and equipment	20	82,705	52,440	1,123
Intangible assets	19	-	13,208	443
Deferred listing costs	15	4,565	-	-
Deferred income tax assets	11	6,947	-	-
Long term investments	16	57,070	-	-
Other receivables		225	-	-
<b>Total non-current assets</b>		<b>151,512</b>	<b>65,648</b>	<b>1,566</b>
<b>Total assets</b>		<b>\$ 560,684</b>	<b>\$ 99,948</b>	<b>\$ 5,610</b>
<b>EQUITY AND LIABILITIES</b>				
<b>Current liabilities</b>				
Trade and other payables	21	\$ 12,669	\$ 7,400	\$ 1,768
Amounts due under line of credit facilities	22	3,009	-	-
Current portion of convertible debenture	23	4,712	-	-
Deposit received for sale of Metals Division	6	-	3,000	-
		<b>20,390</b>	<b>10,400</b>	<b>1,768</b>
Current liabilities classified as held for sale	6	-	255	-
<b>Total current liabilities</b>		<b>20,390</b>	<b>10,655</b>	<b>1,768</b>
<b>Non-current liabilities</b>				
Amounts due under line of credit facilities	22	-	-	105,673
Convertible debenture	23	542,351	-	-
Asset retirement obligation	24	735	329	-
<b>Total non-current liabilities</b>		<b>543,086</b>	<b>329</b>	<b>105,673</b>
<b>Total liabilities</b>		<b>563,476</b>	<b>10,984</b>	<b>107,441</b>
<b>Shareholders' (deficiency)/equity</b>				
Common shares	25	296,419	289,512	30,230
Preferred shares	25	-	-	4,189
Share option reserve	26	22,300	12,775	7,497
Accumulated deficit	27	(321,511)	(213,323)	(143,747)
<b>Total shareholders' (deficiency)/equity</b>		<b>(2,792)</b>	<b>88,964</b>	<b>(101,831)</b>
<b>Total shareholders' equity and liabilities</b>		<b>\$ 560,684</b>	<b>\$ 99,948</b>	<b>\$ 5,610</b>
<b>Net current assets</b>		<b>\$ 388,782</b>	<b>\$ 23,645</b>	<b>\$ 2,276</b>
<b>Total assets less current liabilities</b>		<b>\$ 540,294</b>	<b>\$ 89,293</b>	<b>\$ 3,842</b>

Commitments for expenditure (Note 34)

Subsequent Events (Note 35)

The accompanying notes are an integral part of these Consolidated Financial Statements.

APPROVED BY THE BOARD:

"André Deepwell"  
\_\_\_\_\_  
Director

"Pierre Lebel"  
\_\_\_\_\_  
Director

**SOUTHGOBI ENERGY RESOURCES LTD.**  
**Consolidated Statement of Changes in Equity**  
*(expressed in thousands of U.S. Dollars)*

	Common shares	Preferred shares	Share option reserve	Accumulated deficit	Total
Balances, January 1, 2008	\$ 30,230	\$ 4,189	\$ 7,497	\$ (143,747)	\$ (101,831)
Shares issued for:					
Cash	139,642	-	-	-	139,642
Share issue costs	(3,303)	-	-	-	(3,303)
Mineral properties	5,198	-	-	-	5,198
Conversion of line of credit	107,552	-	-	-	107,552
Conversion of preferred shares	4,189	(4,189)	-	-	-
Exercise of stock options	6,004	-	(1,960)	-	4,044
Stock-based compensation charged to operations	-	-	7,238	-	7,238
Net loss and comprehensive loss for the year	-	-	-	(69,576)	(69,576)
Balances, December 31, 2008	\$ 289,512	\$ -	\$ 12,775	\$ (213,323)	\$ 88,964
Shares issued for:					
Exercise of stock options	\$ 6,907	\$ -	\$ (3,010)	\$ -	\$ 3,897
Stock-based compensation charged to operations	-	-	12,535	-	12,535
Gain on sale of Metals Division (Note 6)	-	-	-	2,617	2,617
Net loss and comprehensive loss for the year	-	-	-	(110,805)	(110,805)
<b>Balances, December 31, 2009</b>	<b>\$296,419</b>	<b>\$ -</b>	<b>\$ 22,300</b>	<b>\$ (321,511)</b>	<b>\$ (2,792)</b>

For details on movement in shares please see Note 25.

The accompanying notes are an integral part of these Consolidated Financial Statements.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Consolidated Statement of Cash Flows

(expressed in thousands of U.S. Dollars)

	Notes	Year ended December 31, 2009	Year ended December 31, 2008 (restated)
<b>OPERATING ACTIVITIES</b>			
Loss for the year from continuing operations before tax		\$ (86,155)	\$ (51,975)
Adjustments for:			
Depreciation and depletion		5,856	494
Share-based compensation		12,195	5,645
Fair value change on embedded derivative		44,980	7,223
Mark to market adjustment on investments		(843)	-
Interest income		(77)	(1,868)
Accrued interest expense		4,721	134
Interest accretion on line of credit facility		-	598
Interest accretion on convertible debenture		2,972	-
Transaction costs on issuance of convertible debenture		9,399	-
Unrealized foreign exchange loss		1,213	4,464
Loss on disposal of property, plant and equipment		245	6
Accretion on asset retirement obligation		40	19
Operating cash flows before movements in working capital		(5,454)	(35,260)
Increase in inventories		(3,443)	(10,857)
Increase in trade and other receivables		(8,379)	(6,801)
Increase in prepaid expenses and deposits		(6,322)	(959)
Increase in trade and other payables		7,595	5,246
Cash used in continuing operations		(16,003)	(48,631)
Cash used in discontinued operations	6	(19,227)	(14,957)
<b>Cash used in operating activities</b>		<b>(35,230)</b>	<b>(63,588)</b>
<b>INVESTING ACTIVITIES</b>			
Purchase of property, plant and equipment		(35,770)	(53,975)
Interest received		37	1,868
Proceeds from disposal of property, plant and equipment		26	10
Purchase of short term investments		(15,000)	-
Purchase of long term investments		(47,450)	-
Increase in other receivables		(225)	-
Cash used in continuing operations		(98,382)	(52,097)
Cash used in discontinued operations		(6,723)	(5,572)
<b>Cash used in investing activities</b>		<b>(105,105)</b>	<b>(57,669)</b>
<b>FINANCING ACTIVITIES</b>			
Proceeds from issuance of common shares and exercise of stock options		3,897	140,383
Increase in deferred charges		(4,565)	-
Proceeds from issuance of convertible debenture, net of issue costs	23	485,000	-
Drawings under line of credit facilities		53,000	2,000
Repayments of line of credit facilities		(50,000)	(8,077)
<b>Cash generated from financing activities</b>		<b>\$ 487,332</b>	<b>\$ 134,306</b>
Effect of foreign exchange rate changes on cash		5	(4,103)
<b>Increase in cash and cash equivalents</b>		<b>347,002</b>	<b>8,946</b>
Cash and cash equivalents, beginning of year		10,340	1,394
<b>Cash and cash equivalents, end of year</b>		<b>\$ 357,342</b>	<b>\$ 10,340</b>
<b>COMPRISED OF:</b>			
Cash and cash equivalents of continuing operations		\$ 357,342	\$ 10,117
Cash and cash equivalents of discontinued operations		-	223
<b>Total cash and cash equivalents</b>		<b>\$ 357,342</b>	<b>\$ 10,340</b>
Cash		\$ 242,352	\$ 6,659
Money market instruments		114,990	3,681
<b>Total cash and cash equivalents</b>		<b>\$ 357,342</b>	<b>\$ 10,340</b>

### Supplemental cash flow information (Note 33)

The accompanying notes are an integral part of these Consolidated Financial Statements.

# **SOUTHGobi ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### **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 Toronto Stock Exchange and Hong Kong Stock Exchange (Note 35.1). 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. 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 Company's Financial Statements and those of all of its controlled subsidiaries ("Consolidated Financial Statements") are presented in U.S. dollars and all values are rounded to the nearest thousand dollars except where otherwise indicated. Information related to shares is presented in thousands except for loss per share information which is presented in U.S. cents.

The Company is a coal producer and a coal exploration and development company. These Consolidated 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.

In February 2009, the Company completed the sale of its Metals Division to Ivanhoe Mines Ltd. for \$3 million. 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.



# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### **2. BASIS OF PREPARATION**

#### **2.1 Statement of compliance**

The Company's Consolidated Financial Statements have been prepared in accordance with and using accounting policies in full compliance 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"), effective for the Company's reporting for the year ended December 31, 2009.

Previously, the Company prepared its Consolidated Annual and Consolidated Interim Financial Statements in accordance with Canadian Generally Accepted Accounting Principles ("GAAP").

#### **2.2 Basis of presentation**

The Company's Consolidated 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 Financial Statements are in accordance with IFRS and any changes from figures previously reported under GAAP have been discussed in Note 3.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### **2. BASIS OF PREPARATION (Continued)**

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

The IASB issued a number of new and revised IASs, IFRSs, amendments and related IFRICs (hereinafter collectively referred to as the “new IFRS”) which are effective for the Company’s financial year beginning on January 1, 2009. For the purpose of preparing and presenting the Consolidated Financial Statements, the Company has consistently adopted all these new standards for the years ended December 31, 2009 and 2008.

At the date of authorization of these Financial Statements, the IASB and IFRIC has issued the following new and revised standards, amendments and interpretations which are not yet effective during the year ended December 31, 2009.

- |                        |   |
|------------------------|---|
| • IFRS (Amendments)    | Amendment to IFRS 5 as part of Improvements to IFRS issued in 2008 <sup>(i)</sup>           |
| • IFRS (Amendments)    | Improvements to IFRS issued in 2009 <sup>(ii)</sup>   |
| • IAS 24 (Revised)     | Related party disclosures <sup>(vi)</sup>   |
| • IAS 27 (Revised)     | Consolidated and separate financial statements <sup>(i)</sup>                               |
| • IAS 32 (Amendment)   | Classification of rights issues <sup>(iv)</sup>   |
| • IAS 39 (Amendment)   | Eligible hedged items <sup>(i)</sup>  |
| • IFRS 1 (Amendment)   | Additional exemptions for first-time adopters <sup>(iii)</sup>                              |
| • IFRS 1 (Amendment)   | Limited exemption from comparative IFRS 7 disclosure for first-time adopters <sup>(v)</sup> |
| • IFRS 2 (Amendment)   | Company cash-settled share-based payment transactions <sup>(iii)</sup>                      |
| • IFRS 3 (Revised)     | Business combinations <sup>(i)</sup>  |
| • IFRS 9               | Financial instruments <sup>(vii)</sup>  |
| • IFRIC 14 (Amendment) | Prepayment of a minimum funding requirement <sup>(vi)</sup>                                 |
| • IFRIC 17             | Distributions of non-cash Assets to owners <sup>(i)</sup>                                   |
| • IFRIC 19             | Extinguishing financial liabilities with equity instruments <sup>(v)</sup>                  |

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

(ii) Amendments are effective for annual periods beginning on or after July 1, 2009 or January 1, 2010, as appropriate

(iii) Effective for annual periods beginning on or after January 1, 2010

(iv) Effective for annual periods beginning on or after February 1, 2010

(v) Effective for annual periods beginning on or after July 1, 2010

(vi) Effective for annual periods beginning on or after January 1, 2011

(vii) Effective for annual periods beginning on or after January 1, 2013

The Company anticipates that the application of these standards, amendments and interpretations will have no material impact on the results and financial positions of the Company.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

December 31, 2009

(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)

### 3. FIRST TIME ADOPTION OF IFRS

The Company 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
<b>Assets</b>	
<b>Current assets</b>	
Cash and cash equivalents	\$ 8,222
Trade and other receivables	80
Prepaid expenses and deposits	124
<b>Total current assets</b>	8,426
<b>Non-current assets</b>	
Property, plant and equipment	149
Intangible assets	158
<b>Total non-current assets</b>	307
<b>Total assets</b>	\$ 8,733
<b>Equity and liabilities</b>	
<b>Current liabilities</b>	
Trade and other payables	\$ 1,035
<b>Total current liabilities</b>	1,035
<b>Total liabilities</b>	1,035
<b>Shareholders' equity</b>	
Common shares	14,183
Additional paid in capital	1,691
Share option reserve	996
Accumulated deficit	(9,172)
<b>Total shareholders' equity</b>	7,698
<b>Total shareholders' equity and liabilities</b>	\$ 8,733

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

December 31, 2009

(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)

### 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

Notes	At December 31,				At
	2008	2007	2006	2005	January 1, 2005
Total assets under Canadian GAAP	\$ 100,132	\$ 5,610	\$ 2,052	\$ 3,775	\$ 8,699
Adjustments for differing accounting treatments:					
- Inclusion of coal division assets (i)	-	-	263	144	35
- Adjustment for asset retirement obligation (v)	(184)	-	-	-	-
<b>Total assets under IFRS</b>	<b>\$ 99,948</b>	<b>\$ 5,610</b>	<b>\$ 2,315</b>	<b>\$ 3,919</b>	<b>\$ 8,734</b>

#### 3.2 Total liabilities

Notes	At December 31,				At
	2008	2007	2006	2005	January 1, 2005
Total liabilities under Canadian GAAP	\$ 11,168	\$ 36,875	\$ 6,287	\$ 693	\$ 1,035
Adjustments for differing accounting treatments:					
- Fair value of embedded derivative on debt (ii)	107,552	70,566	-	-	-
- Conversion of debt (ii)	(107,552)	-	-	-	-
- Adjustment for warrant liability (iv)	-	-	222	222	-
- Conversion of warrant liability (iv)	-	-	(222)	-	-
- Adjustment for asset retirement obligation (v)	(184)	-	-	-	-
<b>Total liabilities under IFRS</b>	<b>\$ 10,984</b>	<b>\$ 107,441</b>	<b>\$ 6,287</b>	<b>\$ 915</b>	<b>\$ 1,035</b>

#### 3.3 Total equity (deficiency)

Notes	At December 31,				At
	2008	2007	2006	2005	January 1, 2005
Total equity (deficiency) under Canadian GAAP	\$ 88,964	\$ (31,266)	\$ (4,235)	\$ 3,082	\$ 7,664
Adjustments for differing accounting treatments:					
- Inclusion of coal division results, net of contribution by Ivanhoe (i)	-	-	263	144	35
- Fair value of embedded derivative on debt (ii)	(107,552)	(70,565)	-	-	-
- Conversion of debt (ii)	107,552	-	-	-	-
- Adjustment for warrant liability (iv)	-	-	-	(222)	-
<b>Total equity (deficiency) under IFRS</b>	<b>\$ 88,964</b>	<b>\$ (101,831)</b>	<b>\$ (3,972)</b>	<b>\$ 3,004</b>	<b>\$ 7,699</b>

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

December 31, 2009

(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)

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

#### 3.4 Net loss

	Notes	Year ended December 31,			
		2008	2007	2006	2005
Net loss and comprehensive loss for the period under Canadian GAAP		\$ 62,386	\$ 26,730	\$ 9,362	\$ 6,214
Basic and Diluted Loss per Share under Canadian GAAP		\$ 0.49	\$ 0.52	\$ 0.56	\$ 0.41
Adjustments for differing accounting treatments:					
- Inclusion of coal division results	(i)	-	2,546	12,168	9,923
- Fair value of embedded derivative on debt	(ii)	7,223	63,286	-	-
- Interest accretion on line of credit facility	(ii)	319	4,224	-	-
- Adjustments on stock based compensation	(iii)	(352)	(50)	(251)	(107)
- Adjustment for warrant liability	(iv)	-	-	450	80
<b>Net loss and comprehensive loss for period under IFRS</b>		<b>\$ 69,576</b>	<b>\$ 96,736</b>	<b>\$ 21,729</b>	<b>\$ 16,110</b>
<b>Basic and Diluted Loss per Share under IFRS</b>		<b>\$ 0.54</b>	<b>\$ 1.89</b>	<b>\$ 1.31</b>	<b>\$ 1.06</b>

#### 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 31) in consideration for the issuance to Ivanhoe of 57,000 common shares and 25,576 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.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### **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 \$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. 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 \$29,963 into 14,710 common shares of the Company (Note 22). 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.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

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### **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.

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

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

##### **(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.

##### **(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.



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### **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 30). 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.

Minority interests in the net assets of consolidated subsidiaries are identified separately from the Company's equity therein. Minority interests consist of the amount of those interests at the date of the original business combination (see Note 4.2) and the minority interests' share of changes in equity since the date of the combination. Losses applicable to the minority 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 minority 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.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

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

#### **4.2 Business combinations (continued)**

Goodwill arising on acquisition is recognized as an asset and initially measured at cost, being the excess of the cost of the business combination over the Company's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognized. If, after reassessment, the Company's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities exceeds the cost of the business combination, the excess is recognized immediately in profit or loss.

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 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.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

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### **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 end of each reporting period.

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 Retirement benefit costs**

Payments to retirement benefit costs are charged as an expense when employees have rendered services entitling them to the contributions.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

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

#### **4.7 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.

Materials and supplies inventory consists of consumable parts and supplies which are valued at lower of weighted 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.

#### **4.8 Property, plant and equipment ("PPE")**

PPE is 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 |

# **SOUTHGOBI ENERGY RESOURCES LTD.**

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

#### **4.8 Property, plant and equipment ("PPE") (Continued)**

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 properties.

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.

#### **4.9 Stripping costs**

Stripping costs incurred during the development of a mine are capitalized into PPE. Stripping costs incurred during the commercial 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 that the previously deferred stripping costs in an area did not give access to. When stripping activities give rise to a future economic benefit, the costs associated with these activities are capitalized into PPE. Capitalized stripping costs are depleted on a unit-of-production basis, using estimated resources as the depletion base.

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

#### **4.10 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. 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.

The commencement of commercial production is deemed to occur on a determination made by management. Management's determination of when commercial production commences is based on several qualitative and quantitative factors including but not limited to the following:

- the elevation or bench where the coal to be mined has been reached
- the commissioning of major mine and plant equipment is completed
- operating results are being achieved in a consistent manner.

However, the production phase does not commence with the removal of *de minimis* saleable mineral materials that occur in conjunction with the removal of overburden or waste material for the purpose of obtaining access to an ore body.

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

The Company recognizes provision for statutory, contractual, constructive or legal obligations, including those associated with the reclamation of mineral properties and mineral assets under PPE, when those obligations result from the acquisition, construction, development or normal operation of the assets. Initially, a provision for an asset retirement obligation is recognized as its present 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.

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

#### **4.12 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 to non-employees 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. Otherwise, share-based payments are measured at the fair value of goods or services received.

##### ***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.

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.

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

#### **4.13 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 at the end of each reporting period.

##### ***Deferred income tax***

Deferred income tax is provided using the liability method on temporary differences, at the end of each reporting period, 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, 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.

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:



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

#### **4.13 Taxation (continued)**

- 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, 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 the end of each reporting period 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 the end of each reporting period 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 end of each reporting period.

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.

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

#### **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 profit and loss.

Financial assets classified as loans and receivables and held to maturity are measured at amortized cost using the effective interest method less any allowance for impairment. The effective interest method is a method of calculating the amortized cost of a financial asset and of allocating interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts (including all fees and points paid or received that form an integral part of the effective interest rate, transaction costs and other premiums or discounts) through the expected life of the financial asset, or, where appropriate, a shorter period.

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 or a significant or prolonged decline in the fair value of that investment below its cost.

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.

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### **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.

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. Transaction costs on financial liabilities classified as FVTPL are expensed as incurred. Fair value changes on financial liabilities classified as FVTPL are recognized through the statement of comprehensive income.

At the end of each reporting period subsequent to initial recognition, financial liabilities at FVTPL are measured at fair value, with changes in fair value recognized directly in profit or loss in the period in which they arise. The net gain or loss recognized in profit or loss excludes any interest paid on the financial liabilities.

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

#### **4.16 Impairment of financial assets**

The Company assesses at the end of each reporting period 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 and other 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.

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

#### **4.17 Derecognition of financial assets and financial liabilities**

Financial assets are derecognized when the rights to receive cash flows from the assets expire or, the financial assets are transferred and the Company has transferred substantially all the risks and rewards of ownership of the financial assets. On derecognition of a financial asset, the difference between the asset's carrying amount and the sum of the consideration received and receivable and the cumulative gain or loss that had been recognized directly in equity is recognized in profit or loss.

For financial liabilities, they are derecognized when the obligation specified in the relevant contract is discharged, cancelled or expires. The difference between the carrying amount of the financial liability derecognized and the consideration paid and payable is recognized in profit or loss.

#### **4.18 Impairment of non-financial assets**

At the end of each reporting period, 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.

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.

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

#### **4.19 Cash and cash equivalents**

Cash and cash equivalents comprise cash at banks and on hand, and short term money market instruments with an original maturity of three months or less, which are readily convertible into a known amount of cash.

#### **4.20 Revenue recognition**

Revenue represents the fair value of consideration received and receivable that are derived from the sales of coal. 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. The revenue from sales of coal in the ordinary course of business is recognized when coal is either loaded onto a truck or when it is unloaded at the final destination, depending on the terms of the contract.

#### **4.21 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.

#### **4.22 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, 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.

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

#### **4.23 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 valuation of embedded derivatives and determination of their expected life; asset retirement obligations; property, plant and equipment, including coal reserves and resources, depreciation and depletion; recoverability of trade and other receivables, 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.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### **5. SEGMENTED INFORMATION**

At December 31, 2009, the Company has one reportable operating segment, being the Mongolian Coal Division. In prior periods, the Company's Metals Division and Indonesia Coal Division were segments 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 the Mongolian 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. The division is principally engaged in the acquisition, exploration and development of coal properties in Mongolia. As at December 31, 2009, the Mongolian Coal Division has achieved commercial production and is earning revenue through the sale of coal to external customers.

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 December 31, 2009, the Mongolian Coal Division had three active customers with the largest customer accounting for 65% of trade receivables and the other customers accounting for the remaining 35% of trade receivables. For the year ended December 31, 2009, the largest customer accounted for 64% of revenues and the other customers accounted for the remaining 36% of revenues.



# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 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, depreciation and depletion expense and impairment charge on assets analyzed by operating segment and reconciled to the Company's Consolidated Financial Statements:

		Discontinued Operations			
	Mongolian Coal Division	Indonesian Coal Division (i)	Metals Division (ii)	Unallocated (iii)	Consolidated Total
<b>Segment assets</b>					
As at December 31, 2009	<b>\$129,454</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$431,230</b>	<b>\$ 560,684</b>
As at December 31, 2008	76,611	14,836	638	7,863	99,948
As at December 31, 2007	2,509	-	1,132	1,969	5,610
<b>Segment liabilities</b>					
As at December 31, 2009	<b>7,300</b>	<b>-</b>	<b>-</b>	<b>556,176</b>	<b>563,476</b>
As at December 31, 2008	3,101	811	255	6,817	10,984
As at December 31, 2007	836	-	270	106,335	107,441
<b>Segment (profits)/losses</b>					
For year ended December 31, 2009	<b>(6,203)</b>	<b>31,088</b>	<b>-</b>	<b>85,920</b>	<b>110,805</b>
For year ended December 31, 2008	25,434	9,690	7,911	26,541	69,576
<b>Segment revenues</b>					
For year ended December 31, 2009	<b>36,038</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>36,038</b>
For year ended December 31, 2008	3,126	-	-	-	3,126
<b>Capital expenditures</b>					
For year ended December 31, 2009	<b>35,706</b>	<b>6,511</b>	<b>-</b>	<b>64</b>	<b>42,281</b>
For year ended December 31, 2008	53,960	481	53	15	54,509
<b>Depreciation and depletion expense</b>					
For year ended December 31, 2009	<b>5,837</b>	<b>-</b>	<b>-</b>	<b>19</b>	<b>5,856</b>
For year ended December 31, 2008	395	-	54	99	548
<b>Impairment charge on assets</b>					
For year ended December 31, 2009 <sup>(iv)</sup>	<b>-</b>	<b>15,135</b>	<b>-</b>	<b>-</b>	<b>15,135</b>
For year ended December 31, 2008	-	-	493	-	493
(i)	The Indonesian Coal Division was treated as discontinued operations for the years ended December 31, 2008 and 2009 (Note 6)				
(ii)	The Metals Division was treated as discontinued operations for the years ended December 31, 2008 and 2009 and the assets and liabilities of the Metals Division were reclassified as held for sale as at December 31, 2008 (Note 6)				
(iii)	The unallocated amount contains all amounts associated with the Corporate Division				
(iv)	The impairment charge related to the Indonesia Coal Division is discussed further in Note 6				

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

### 5. SEGMENTED INFORMATION (Continued)

At December 31, 2009, the Company operates in three geographical areas, being Canada, Hong Kong and Mongolia. Prior to December 23, 2009, the Company had operations in Indonesia (Note 6). 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
<b>Revenues</b>					
For year ended December 31, 2009	\$ 36,038	\$ -	\$ -	\$ -	\$ 36,038
For year ended December 31, 2008	3,126	-	-	-	3,126
<b>Non-current assets</b>					
As at December 31, 2009	89,587	-	49	61,876	151,512
As at December 31, 2008	51,939	13,689	-	20	65,648
As at December 31, 2007	1,398	62	-	106	1,566

### 6. DISCONTINUED OPERATIONS

The loss from discontinued operations is broken down as follows:

	Year ended December 31, 2009	Year ended December 31, 2008
Discontinued operations - Metals Division	\$ -	\$ 7,911
Discontinued operations - Indonesia Coal Division	31,088	9,690
Net loss from discontinued operations	\$ 31,088	\$ 17,601
Basic and diluted loss per share from discontinued operations	\$ 0.23	\$ 0.14

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

### **6. DISCONTINUED OPERATIONS (Continued)**

#### **6.1 Indonesia Coal Division**

The Company sold the Indonesia Coal Division, which is composed entirely of the Mamahak Coal Project ("Mamahak"), effective December 15, 2009. The Company divested its 85% interest in Mamahak to Kangaroo Resources Limited ("Kangaroo") for consideration comprising of \$1 million in cash and 50 million shares of Kangaroo with a fair value of \$8,776. Kangaroo is listed on the Australian Securities Exchange (KRL: ASX). The transaction was completed on December 23, 2009 and the Company incurred transaction costs of \$1 million related to the disposition of Mamahak. As a result of this transaction, the Company held 6.7% of the outstanding shares in Kangaroo on the closing date of the transaction and those shares are subject to a twelve month lock-up.

Based on the terms of the agreement with Kangaroo, the estimated net recoverable value, determined by the estimated fair value of Mamahak less the selling costs, has resulted in an impairment charge of \$15,135.

The losses from discontinued operations of the Indonesia Coal Division for the years ended December 31, 2009 and 2008 are as follows:

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Administration expenses	\$ 40	\$ (48)
Evaluation and exploration expenses <sup>(i)</sup>	15,916	9,740
Finance costs	8	-
Interest income	(11)	(2)
Impairment charge on Indonesia Coal Division	15,135	-
<b>Net loss from discontinued operations</b>	<b>\$ 31,088</b>	<b>\$ 9,690</b>
<b>Basic and diluted loss per share from discontinued operations</b>	<b>\$ 0.23</b>	<b>\$ 0.08</b>

(i) Share-based compensation (a non-cash item) of \$340 (2008: \$102) has been included in Evaluation and exploration expenses

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## **Notes to the Consolidated Financial Statements**

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### **6. DISCONTINUED OPERATIONS (Continued)**

#### **6.2 Metals Division**

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 22). Ivanhoe 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 deposits received under current liabilities. The Company has recorded a gain of \$2,617 in the year ended December 31, 2009 on the sale of the Metals Division and this gain was 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 its 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. Upon the closing of the sale of the Metals Division on February 2, 2009, there was a cash outflow of \$223, all other assets and liabilities classified as held for sale as at December 31, 2008 were disposed upon the closing of the sale of the Metals Division.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

December 31, 2009

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### 6. DISCONTINUED OPERATIONS (Continued)

#### 6.2 Metals Division (continued)

The losses from discontinued operations of the Metals Division for the year ended December 31, 2008 are as follows:

	Year ended December 31, 2008
Evaluation and exploration expenses <sup>(i)</sup>	\$ 7,418
Impairment of intangible assets	493
Net loss from discontinued operations	\$ 7,911
<hr/>	
Basic and diluted loss per share from discontinued operations	\$ 0.06

(i) Share-based compensation (a non-cash item) of \$nil (2008: \$1,491) has been included in Evaluation and exploration expenses

The carrying values of net assets classified as held for sale as at December 31, 2008 are as follows:

Assets	As at December 31, 2008
<b>Current assets</b>	
Cash and cash equivalents	\$ 223
Trade and other receivables	184
Prepaid expenses and deposits	134
Property, plant and equipment	97
<b>Total current assets classified as held for sale</b>	<b>\$ 638</b>
<hr/>	
<b>Current liabilities</b>	
Trade and other payables	\$ 255
<b>Total current liabilities classified as held for sale</b>	<b>\$ 255</b>

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

### 7. COST OF SALES

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

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Operating expenses <sup>(i)</sup>	\$ 23,611	\$ 1,863
Depreciation and depletion	5,814	314
<b>Cost of sales</b>	<b>\$ 29,425</b>	<b>\$ 2,177</b>

(i) Share-based compensation (a non-cash item) of \$1,590 (2008: \$540) has been included in Operating expenses

### 8. ADMINISTRATION EXPENSES

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

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Corporate administration	\$ 2,839	\$ 2,123
Legal	912	305
Professional fees	3,159	804
Listing fees <sup>(ii)</sup>	2,470	6,715
Salaries and benefits <sup>(i)</sup>	14,024	5,618
Depreciation	19	98
Foreign exchange loss	1,112	4,695
<b>Administration expenses</b>	<b>\$ 24,535</b>	<b>\$ 20,358</b>

(i) Share-based compensation (a non-cash item) of \$10,471 (2008: \$3,770) has been included in Salaries and benefits

(ii) Listing fees of \$4,565 were deferred in the year ended December 31, 2009 (Note 15)

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

December 31, 2009

(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)

### 9. EVALUATION AND EXPLORATION EXPENSES

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

	Year ended December 31, 2009	Year ended December 31, 2008
Mongolian Coal Division <sup>(i)</sup>	\$ 5,399	\$ 26,445
<b>Evaluation and exploration expenses</b>	<b>\$ 5,399</b>	<b>\$ 26,445</b>

(i) Share-based compensation (a non-cash item) of \$134 (2008: \$1,335) has been included in Evaluation and exploration expenses

### 10. FINANCE COSTS

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

	Year ended December 31, 2009	Year ended December 31, 2008
Fair value change of embedded derivatives in convertible debenture <sup>(iii)</sup>	\$ 44,980	\$ -
Fair value change of embedded derivative in line of credit facility <sup>(ii)</sup>	-	7,223
Interest accretion on convertible debenture <sup>(iii)</sup>	2,972	-
Interest accretion on line of credit facility <sup>(ii)</sup>	-	598
Interest expense on convertible debenture <sup>(iii)</sup>	4,712	-
Interest expense on line of credit facilities <sup>(ii)</sup>	1,651	149
Transaction costs on issuance of convertible debenture <sup>(iii)</sup>	9,399	-
Mark to market gain on investments <sup>(i)</sup>	(843)	-
Accretion of asset retirement obligation	40	19
<b>Finance costs</b>	<b>\$ 62,911</b>	<b>\$ 7,989</b>

(i) Further information regarding this charge is disclosed in Note 16

(ii) Further information regarding this charge is disclosed in Note 22

(iii) Further information regarding this charge is disclosed in Note 23

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

### 11. TAXES

The Company and its subsidiaries in Canada are subject to Canadian federal and provincial tax for the estimated assessable profit for the years ended December 31, 2009 and 2008 at a rate of 30% and 31%, respectively. The Company had no assessable profit in Canada for the years ended December 31, 2009 and 2008.

The Company's subsidiaries in Hong Kong are subject to Hong Kong profits tax for the years ended December 31, 2009 and 2008 at a rate of 16.5%. No Hong Kong profits tax was provided for as the Company had no assessable profit arising in or derived from Hong Kong in the years ended December 31, 2009 and 2008.

The Company's subsidiaries in Mongolia are subject to Mongolian income tax for the years ended December 31, 2009 and 2008 at a rate of 25%. In the year ended December 31, 2009 the Company recorded a current income tax charge of \$509 (2008: \$nil) related to assessable profit derived from Mongolia.

Taxation from other relevant jurisdictions is calculated at the rates prevailing in each of those jurisdictions respectively.

The tax expense for the Company can be reconciled to the loss for the period per the Consolidated Statement of Comprehensive Income as follows:

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Loss from continuing operations before tax	\$ 86,155	\$ 51,975
Loss from discontinued operations before tax	31,088	17,601
Loss from operations before tax	117,243	69,576
Statutory tax rate	30.00%	31.00%
Recovery of income taxes based on combined Canadian federal and provincial statutory rates	35,173	21,568
Deduct:		
Lower effective tax rate in foreign jurisdictions	(992)	(2,118)
Tax effect of tax losses and temporary differences not recognized	(1,938)	(15,712)
Non-deductible expenses	(22,956)	(2,902)
Effect of change in future tax rates	(2,849)	(836)
<b>Tax recovery for the year</b>	<b>\$ 6,438</b>	<b>\$ -</b>



# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

December 31, 2009

(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)

### 11. TAXES (Continued)

The Company's recognized deferred income tax assets are as follows:

	As at December 31, 2009	As at December 31,	
		2008	2007
Tax loss carry-forwards	\$ 5,793	\$ -	\$ -
Property, plant and equipment	1,135	-	-
Other assets	19	-	-
<b>Total deferred income tax assets</b>	<b>\$ 6,947</b>	<b>-</b>	<b>-</b>

The Company's unrecognized deferred income tax assets are as follows:

	As at December 31, 2009	As at December 31,	
		2008 <sup>(i)</sup>	2007
Tax loss carry-forwards	\$ 12,884	\$ 13,732	\$ 14,977
Property, plant and equipment	56	504	1,075
Share issue costs	4,902	687	16
Unrealized foreign exchange losses	5,582	2,319	1
Convertible debenture	-	-	-
Fair value of embedded derivatives	-	-	20,930
Other assets	1,275	1,146	1,477
<b>Total unrecognized deferred income tax assets</b>	<b>\$ 24,699</b>	<b>\$ 18,388</b>	<b>\$ 38,476</b>

(i) 2008 figures exclude deferred income tax assets associated with assets and liabilities classified as held for sale

The Company's unrecognized deferred income tax assets associated with assets held for sale as at December 31, 2008 are as follows:

	As at December 31, 2008
Tax loss carry-forwards	\$ 3,892
Property, plant and equipment	482
<b>Total deferred income tax assets</b>	<b>\$ 4,374</b>

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 11. TAXES (Continued)

At December 31, 2009 the Company and its subsidiaries have unrecognized capital losses and non-capital losses for income tax purposes of approximately \$97,869 (2008: \$64,418; 2007: \$56,313) that may be used to offset future taxable income as follows:

As at December 31, 2009				
		Local currency	U.S. Dollar Equivalent	Expiry dates
<b>Non-capital losses</b>				
Canadian Dollar	Cdn\$	35,922	\$ 34,108	2010-2029
Mongolian Tugrik	MNT	33,496,611	29,243	2010-2020
Singapore Dollar	SGD	48	34	indefinite
Hong Kong Dollar	HKD	7,898	1,018	indefinite
			\$ 64,403	
<b>Capital losses</b>				
Canadian Dollar	Cdn\$	35,246	\$ 33,466	indefinite

### 12. LOSS PER SHARE

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

	Year ended December 31, 2009	Year ended December 31, 2008
Net loss from continuing operations for the purpose of basic and diluted loss per share	\$ 79,717	\$ 51,975
Net loss from discontinued operations for the purpose of basic and diluted loss per share	\$ 31,088	\$ 17,601
Weighted average number of shares for the purpose of basic and diluted loss per share	133,499	128,354

The basic loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding during the year. The diluted loss per share reflects the potential dilution of common share equivalents, such as preference shares, outstanding stock options, share purchase warrants and convertible debentures, in the weighted average number of common shares outstanding during the year, if dilutive. All of the stock options and the convertible debenture were anti-dilutive for the years ended December 31, 2009 and 2008.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

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### **13. CASH AND CASH EQUIVALENTS**

Cash and cash equivalents of the Company are comprised of bank balances and short term money market instruments with an original maturity of three months or less. The Company's bank balances and cash equivalents carry prevailing market interest rates which ranged from 0.10% to 0.30% as at December 31, 2009. The Company's cash and cash equivalents are denominated in the following currencies:

	<b>As at December 31, 2009</b>	<b>As at December 31,</b>	
		<b>2008</b>	<b>2007</b>
Denominated In U.S. dollars	<b>\$ 357,163</b>	\$ 6,126	\$ 1,111
Others	<b>179</b>	3,991	283
<b>Total cash and cash equivalents</b>	<b>\$ 357,342</b>	<b>\$ 10,117</b>	<b>\$ 1,394</b>

### **14. TRADE AND OTHER RECEIVABLES**

The Company's trade and other receivables arise from two main sources: trade receivables due from customers for coal sales and value added tax ("VAT") and goods and services tax ("GST") receivable due from various government taxation authorities. These are broken down as follows:

	<b>As at December 31, 2009</b>	<b>As at December 31,</b>	
		<b>2008</b>	<b>2007</b>
Trade receivables	<b>\$ 5,200</b>	\$ 1,743	\$ -
VAT/GST receivable	<b>7,029</b>	5,357	720
Other receivables	<b>99</b>	190	40
<b>Total trade and other receivables</b>	<b>\$ 12,328</b>	<b>\$ 7,290</b>	<b>\$ 760</b>

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 14. TRADE AND OTHER RECEIVABLES (Continued)

Below is an aged analysis of the Company's trade and other receivables:

	As at December 31, 2009	As at December 31,	
		2008	2007
Less than 1 month	\$ 5,730	\$ 2,034	\$ 188
1 to 3 months	3,463	443	300
3 to 6 months	2,613	1,705	272
Over 6 months	522	3,108	-
<b>Total trade and other receivables</b>	<b>\$ 12,328</b>	<b>\$ 7,290</b>	<b>\$ 760</b>

At December 31, 2009, 91% of the trade and other receivables that were outstanding over one month are VAT/GST receivables and 100% of the trade and other receivables that were outstanding over six months are VAT/GST receivables. The Company anticipates full recovery of these amounts and therefore no impairment has been recorded against these receivables. The credit risk on the GST/VAT receivable has been further discussed in Note 29.

The Company holds no collateral for any receivable amounts outstanding as at December 31, 2009.

Included in trade and other receivables of the Company are amounts due from related parties which are disclosed in Note 30. The amounts are unsecured, interest free and repayable upon written notice given from the Company.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 15. DEFERRED LISTING COSTS

The deferred listing costs consist of legal, accounting and professional fees related to equity fundraising through an international offering of shares ("international offering") (Note 35.1) and a simultaneous secondary listing on the Hong Kong Stock Exchange ("HKEX"). The Company had previously expensed all costs associated with the international offering due to the liquidity issues in the credit markets, along with the increased cost of obtaining capital and the reduced availability of equity funding. However, in the fourth quarter of 2009, the Company achieved significant milestones that provided evidence that the Company would successfully be able to raise equity through the international offering and that the secondary listing would be completed. The Company deferred listing costs that were incurred after the achievement of those milestones.

On January 29, 2010, the Company successfully concluded the international offering and began trading on the HKEX (Note 35.1). The deferred listing costs as at December 31, 2009 of \$4,565 and additional listing costs incurred until the completion date of the international offering will be offset against the net proceeds from the international offering as share issue costs.

### 16. INVESTMENTS

The Company's investments are broken down as follows:

	As at December 31, 2009	As at December 31,	
		2008	2007
<b>Short term investments</b>			
Money market investments <sup>(i)</sup>	\$ 14,999	\$ -	\$ -
<b>Long term investments</b>			
Investment in Kangaroo Resources <sup>(iii)</sup>	9,876	-	-
Money market investments <sup>(ii)</sup>	47,194	-	-
	57,070		
<b>Total investments</b>	<b>\$ 72,069</b>	<b>\$ -</b>	<b>\$ -</b>

(i) Money market investments with original maturities greater than ninety days and less than one year

(ii) Money market investments with original maturities greater than one year

(iii) For more information regarding this investment see Note 6.1

# SOUTHGOBI ENERGY RESOURCES LTD.

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### 17. INVENTORIES

The Company's inventories are broken down as follows:

	As at December 31, 2009	As at December 31,	
		2008	2007
Stockpiles <sup>(i)</sup>	\$ 9,553	\$ 13,158	\$ -
Materials and supplies	6,831	519	-
<b>Total inventories</b>	<b>\$ 16,384</b>	<b>\$ 13,677</b>	<b>\$ -</b>

(i) Coal inventories are stated at production cost

The amount of inventories recognized as an expense during the year ended December 31, 2009 is \$22,035 (2008: \$1,212). As at December 31, 2009, the Company anticipates the entire stockpiles balance of \$9,553 will be realized within twelve months.

### 18. PREPAID EXPENSES AND DEPOSITS

The prepaid expenses and deposits for the Company are broken down as follows:

	As at December 31, 2009	As at December 31,	
		2008	2007
Security deposits	\$ 619	\$ 532	\$ 335
Insurance	557	234	71
Prepaid exploration license costs	1,023	1,111	1,209
Prepaid income taxes	3,109	-	-
Vendor pre-payments	2,683	609	-
Other	128	92	275
<b>Total prepaid expenses and deposits</b>	<b>\$ 8,119</b>	<b>\$ 2,578</b>	<b>\$ 1,890</b>

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 19. INTANGIBLE ASSETS

The following table shows the Company's cumulative expenditures made as of December 31, 2008 and December 31, 2009:

	Mineral properties - Indonesian Coal Division	Mineral properties - Metals Division	Total
Balance, As at January 1, 2007	\$ -	\$ 443	\$ 443
Additions	-	-	-
Depletion	-	-	-
Balance, As at December 31, 2007	-	443	443
Additions	13,208	50	13,258
Depletion	-	-	-
Impairment	-	(493)	(493)
Balance, As at December 31, 2008	13,208	-	13,208
Sale of Indonesia Coal Division (Note 6)	(13,208)	-	(13,208)
<b>Balance, As at December 31, 2009</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>

The Company held 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 \$13,208, comprised of \$8,014 cash and \$5,168 settled by 320 common shares of the Company at Cdn\$16.15 per share as specified in the agreement with Score. The Company disposed of Mamahak on December 15, 2009 (Note 6.1).

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 20. 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
<b>Cost</b>								
As at January 1, 2007	\$ 203	\$ 195	\$ 62	\$ 108	\$ -	\$ -	\$ 150	\$ 718
Additions	152	179	81	215	-	-	235	862
Disposals	(44)	-	(14)	-	-	-	-	(58)
As at December 31, 2007	311	374	129	323	-	-	385	1,522
Additions	38,283	272	32	1,908	433	3,422	11,026	55,376
Disposals	(50)	(120)	(68)	(20)	-	-	-	(258)
As at December 31, 2008	38,544	526	93	2,211	433	3,422	11,411	56,640
Additions	28,900	98	409	538	1,663	5,669	6,225	43,502
Disposals	(756)	(37)	(7)	(125)	-	-	(7)	(932)
Sale of Indonesia Coal Division (Note 6)	-	-	-	-	(1,820)	(3,006)	(2,738)	(7,564)
Reclassifications	-	-	4	598	13,318	-	(13,920)	-
<b>As at December 31, 2009</b>	<b>\$ 66,688</b>	<b>\$ 587</b>	<b>\$ 499</b>	<b>\$ 3,222</b>	<b>\$ 13,594</b>	<b>\$ 6,085</b>	<b>\$ 971</b>	<b>\$ 91,646</b>
<b>Accumulated depreciation</b>								
As at January 1, 2007	\$ (60)	\$ (95)	\$ (11)	\$ (57)	\$ -	\$ -	\$ -	\$ (223)
Charge for the year	(70)	(42)	(3)	(62)	-	-	-	(177)
Eliminated on disposals	-	-	1	-	-	-	-	1
As at December 31, 2007	(130)	(137)	(13)	(119)	-	-	-	(399)
Charge for the year	(3,465)	(204)	(23)	(68)	(77)	(85)	-	(3,922)
Eliminated on disposals	11	84	17	9	-	-	-	121
As at December 31, 2008	(3,584)	(257)	(19)	(178)	(77)	(85)	-	(4,200)
Charge for the period	(4,003)	(76)	(57)	(405)	(834)	(85)	-	(5,460)
Eliminated on disposals	613	34	4	-	-	-	-	651
Sale of Indonesia Coal Division (Note 6)	-	-	-	-	28	40	-	68
<b>As at December 31, 2009</b>	<b>\$ (6,974)</b>	<b>\$ (299)</b>	<b>\$ (72)</b>	<b>\$ (583)</b>	<b>\$ (883)</b>	<b>\$ (130)</b>	<b>\$ -</b>	<b>\$ (8,941)</b>
<b>Net book value</b>								
As at December 31, 2007	\$ 181	\$ 237	\$ 116	\$ 204	\$ -	\$ -	\$ 385	\$ 1,123
As at December 31, 2008	\$ 34,960	\$ 269	\$ 74	\$ 2,033	\$ 356	\$ 3,337	\$ 11,411	\$ 52,440
<b>As at December 31, 2009</b>	<b>\$ 59,714</b>	<b>\$ 288</b>	<b>\$ 427</b>	<b>\$ 2,639</b>	<b>\$ 12,711</b>	<b>\$ 5,955</b>	<b>\$ 971</b>	<b>\$ 82,705</b>



# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 21. TRADE AND OTHER PAYABLES

Trade and other payables of the Company are principally comprised of amounts outstanding for trade purchases relating to coal mining and exploration activities and amounts payable for financing activities. The usual credit period taken for trade purchases is between 30 to 90 days.

The following is an aged analysis of the trade and other payables:

	<b>As at December 31, 2009</b>	<b>As at December 31,</b>	
		<b>2008</b>	<b>2007</b>
Less than 1 month	\$ 9,630	\$ 4,723	\$ 76
1 to 3 months	892	1,960	198
3 to 6 months	705	701	210
Over 6 months	1,442	16	1,284
<b>Total trade and other payables</b>	<b>\$ 12,669</b>	<b>\$ 7,400</b>	<b>\$ 1,768</b>

Included in trade and other payables are amounts due to related parties which are disclosed in Note 30.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 22. LINE OF CREDIT FACILITIES

The movement of all the amounts due under the various line of credit facilities is as follows:

	First funding agreement	Second funding agreement	Ivanhoe credit facility	Bank line of credit	Total
Balance, as at January 1, 2007	\$ 5,836	\$ -	\$ -	\$ -	\$ 5,836
Amounts advanced	22,712	6,000	-	-	28,712
Interest expense	1,307	51	-	-	1,358
Interest accretion	6,481	-	-	-	6,481
Fair value change on embedded derivative	63,286	-	-	-	63,286
Balance, as at December 31, 2007	99,622	6,051	-	-	105,673
Amounts advanced	-	2,000	-	-	2,000
Interest expense	108	26	-	-	134
Interest accretion	598	-	-	-	598
Fair value change on embedded derivative	7,223	-	-	-	7,223
Repayment of line of credit facility	-	(8,077)	-	-	(8,077)
Conversion of line of credit facility	(107,551)	-	-	-	(107,551)
Balance, as at December 31, 2008	-	-	-	-	-
Amounts advanced	-	-	50,000	3,000	53,000
Interest expense	-	-	1,642	9	1,651
Repayment of line of credit facility	-	-	(51,642)	-	(51,642)
<b>Balance, as at December 31, 2009</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 3,009</b>	<b>\$ 3,009</b>

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 22. LINE OF CREDIT FACILITIES (Continued)

The amounts due under the line of credit facilities are further broken down as follows:

	As at December 31, 2009	As at December 31,	
		2008	2007
<b>First funding agreement</b>			
Debt host	\$ -	\$ -	\$ 7,657
Interest payable	-	-	1,486
Interest accretion on line of credit facility	-	-	6,481
Fair value of embedded derivative	-	-	83,998
	-	-	99,622
<b>Second funding agreement</b>			
Principal amount	-	-	6,000
Interest payable	-	-	51
	-	-	6,051
<b>Ivanhoe credit facility</b>			
Principal amount	-	-	-
Interest payable	-	-	-
	-	-	-
<b>Bank line of credit</b>			
Principal amount	3,000	-	-
Interest payable	9	-	-
	3,009	-	-
Amounts due under line of credit facilities	\$ 3,009	\$ -	\$ 105,673
<b>Financial statement presentation</b>			
<b>CURRENT LIABILITIES</b>			
Amounts due under line of credit facilities	\$ 3,009	\$ -	\$ -
<b>NON-CURRENT LIABILITIES</b>			
Amounts due under line of credit facilities	-	-	105,673
	\$ 3,009	\$ -	\$ 105,673

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### **22. LINE OF CREDIT FACILITIES (Continued)**

#### **22.1 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 31) in consideration for the issuance to Ivanhoe of 57,000 common shares and 25,576 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 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 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 \$29,983 of debt into 14,709 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. The conversion feature was considered an embedded derivative and this feature has been discussed further in Note 22.5.

#### **22.2 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 were paid to Ivanhoe representing repayment in full of the principal of \$8,000 and accrued interest of \$77 owing on the second funding agreement. The second funding agreement was then terminated.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### **22. LINE OF CREDIT FACILITIES (Continued)**

#### **22.3 Ivanhoe credit facility**

On December 30, 2008, the Company established a credit facility with Ivanhoe ("Ivanhoe credit facility") which allowed the Company to obtain advances from Ivanhoe to a maximum of \$30 million. The Ivanhoe credit facility is for a term of one year and the Company may request a one year extension. Such an extension shall be at the sole discretion of Ivanhoe. The credit facility is unsecured, non-convertible and carries an interest rate equal to LIBOR plus 750 basis points.

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

On November 30, 2009, funds in the amount of \$51,642 were paid to Ivanhoe representing repayment in full of the principal of \$50,000 and accrued interest of \$1,642 owing on the Ivanhoe credit facility. The Ivanhoe credit facility was then terminated.

#### **22.4 Bank line of credit**

On December 18, 2009, the Company established a line of credit facility with Golomt Bank in Mongolia ("Bank line of credit"). The Bank line of credit facility is a twelve month revolving line of credit facility with a maximum draw-down available of \$3 million. The facility bears interest at 13% per annum and is secured by equipment in Mongolia to a value of not less than 150% of the total facility amount.

The Bank line of credit facility will be used by the Company's Mongolian subsidiaries as part of their working capital management. At December 31, 2009 the Company had received advances of \$3,000 against the Bank line of credit and has accrued interest expense of \$9 for the year ended December 31, 2009.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

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### **22. LINE OF CREDIT FACILITIES (Continued)**

#### **22.5 Embedded derivative**

The Company accounted for any amounts drawn on the first funding agreement (Note 22.1) 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 \$29,963 of debt into 14,709 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 which was converted and recorded as 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 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.

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.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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## 22. LINE OF CREDIT FACILITIES (Continued)

### 22.5 Embedded derivative (continued)

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	\$ 13,212	\$ 2,000	\$ 2,500	\$ 2,000	\$ 29,855	\$ 29,963
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%
<i>Call option</i>							
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
<i>Put option</i>							
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
<b>Net embedded derivative</b>	<b>\$ 1,185</b>	<b>\$ 15,657</b>	<b>\$ 4,893</b>	<b>\$ 4,280</b>	<b>\$ 3,788</b>	<b>\$ 83,998</b>	<b>\$ 91,222</b>

As at December 31, 2007, \$63,267 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 \$91,203 and \$7,223 had been recorded as a charge against income within finance costs in the year ended December 31, 2008. The debt host 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 \$6,481.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

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### **23. CONVERTIBLE DEBENTURE**

On November 19, 2009, the Company issued a convertible debenture to a wholly owned subsidiary of the China Investment Corporation ("CIC") for \$500 million, which is secured and bears interest at 8.0% with a maximum term of 30 years. The financing is required primarily to support the accelerated investment program in Mongolia and up to \$120 million of the financing may also be used for working capital, repayment of debt due on funding, general and administrative expense and other general corporate purposes.

The key commercial terms of the financing include:

- Interest - 8% per annum (6.4% payable semi-annually in cash and 1.6% payable annually in the Company's shares, where the number of shares to be issued is calculated based on the 50-day volume-weighted average price ("VWAP").
- Term - Maximum of 30 years.
- Security - First charge over the Company's assets, including shares of its material subsidiaries.
- Conversion price - The conversion price is set as the lower of Cdn\$11.88 or the 50-day VWAP at the date of conversion, with a floor price of Cdn\$8.88 per share.
- Conversion timing - The Company and CIC each have various rights to call conversion of the debenture into common shares. CIC has the right to convert the debenture, in whole or in part, into common shares twelve months after the date of issue. The Company has the right to call for the conversion of up to \$250 million of the debenture on the earlier of twenty four months after the issue date, if the conversion price is greater than Cdn\$10.66, or upon the Company achieving a public float of 25% of its common shares under certain agreed circumstances, if the conversion price is greater than Cdn\$10.66.
- Company's normal conversion right - After sixty months from the issuance date, at any time that the conversion price is greater than Cdn\$10.66, the Company will be entitled to require conversion of the outstanding convertible debenture, in whole or in part, into common shares at the conversion price.
- Representation on the Company's Board - While the debenture loan is outstanding, or while CIC has a minimum 15% direct or indirect stake in the Company, CIC has the right to nominate one director to the Company's Board. The Company currently has eight Board members.
- Voting restriction - CIC has agreed that it will not have any voting rights in the Company beyond 29.9% if CIC ever acquires ownership of such a shareholder stake through exercising the debenture.



# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

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### **23. CONVERTIBLE DEBENTURE (Continued)**

The key commercial terms of the financing include (continued):

- Pre-emption rights - While the debenture loan is outstanding, or while CIC has a 15% direct or indirect stake in the Company, CIC has certain pre-emption rights on a pro-rata basis to subscribe for any new shares to be allotted and issued by the Company for the period which the debenture is outstanding. The pre-emption rights will not apply to new shares issued pursuant to pro-rata public equity offerings made to all shareholders, exercise of stock options and shares issued to achieve a 25% public float.
- Right of first offer - While a portion of the debenture is outstanding, or while CIC has a 15% direct or indirect stake in the Company, CIC has the right of first offer for any direct and indirect sale of Ivanhoe's ownership stake in the Company. At December 31, 2009 Ivanhoe owned directly and indirectly approximately 79% of the Company's issued and outstanding shares.
- Registration Rights - CIC has registration rights under applicable Canadian provincial securities laws in connection with the common shares issuable upon conversion of the debenture.

The Company identified that the convertible debenture is a debt host contract to be presented as a liability and contains no equity components. The Company also concluded that the convertible debenture is a hybrid instrument, containing a debt host component and three embedded derivatives - the investor's conversion option, the issuer's conversion option and the equity based interest payment provision (the 1.6% share interest payment) (the "embedded derivatives"). The debt host component is classified as other financial liabilities (Note 29.1) and will be measured at amortized cost using the effective interest rate method and the embedded derivatives are classified as FVTPL (Note 29.1) and all changes in fair value will be recorded in income. The difference between the host debt component and the principal amount of the loan outstanding will be accreted to income over the expected life of the convertible debenture.

The embedded derivative was valued upon initial measurement and at December 31, 2009 using a Monte Carlo simulation valuation model. A Monte Carlo simulation model is a valuation model that relies on random sampling and is often used when modeling systems with a large number of inputs and where there is significant uncertainty in the future value of inputs and where the movement of the inputs can be independent of each other. Some of the key inputs used by the Company in its Monte Carlo simulation included: the floor and ceiling conversion prices, the risk-free rate of return, expected volatility of the stock price, forward foreign exchange rate curves (between the Cdn\$ and U.S.\$) and spot foreign exchange rates.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

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### **23. CONVERTIBLE DEBENTURE (Continued)**

Based on the Company's valuation as at November 19, 2009, the closing date of the convertible debenture, the value of the embedded derivatives was \$313,292 and the value of the debt component was \$186,708. The transaction costs of \$15,000 were applied on a pro-rata basis to the debt host and embedded derivatives and transaction costs of \$9,399 associated with the embedded derivatives were expensed as financing costs and transaction costs of \$5,601 associated with the debt host were netted against the debt host component.

Based on the Company's valuation model as at December 31, 2009, the fair value of the embedded derivatives had increased by \$44,980 which was expensed as financing costs for the year ended December 31, 2009. In the year ended December 31, 2009, the Company also recorded an accretion expense of \$2,972 related to the debt host component of the convertible debenture and an interest expense of \$4,712 related to the convertible debenture. To calculate the accretion the Company used an expected life of 30 years.

The assumptions used in Monte Carlo valuation models as at December 31, 2009 and November 19, 2009 are as follows:

	<b>As at December 31, 2009</b>	<b>As at November 19, 2009</b>
Floor conversion price	<b>Cdn\$8.88</b>	Cdn\$8.88
Ceiling conversion price	<b>Cdn\$11.88</b>	Cdn\$11.88
Expected volatility <sup>(i)</sup>	<b>75%</b>	80%
Risk-free rate of return	<b>4.09%</b>	3.92%
Foreign exchange spot rate (U.S.\$ to Cdn\$)	<b>0.96</b>	0.94
Forward foreign exchange rate curve (U.S.\$ to Cdn\$)	<b>0.90 - 0.95</b>	0.90 - 0.94

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

The movement of all the amounts due under the convertible debenture is as follows:

Balance, as at December 31, 2007 and December 31 2008	\$ -
Amounts advanced	<b>500,000</b>
Transaction costs	<b>(5,601)</b>
Accrued interest payable	<b>4,712</b>
Interest accretion	<b>2,972</b>
Fair value change on embedded derivatives	<b>44,980</b>
<b>Balance, as at December 31, 2009</b>	<b>\$ 547,063</b>

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### **23. CONVERTIBLE DEBENTURE (Continued)**

The amounts due under the convertible debenture are further broken down as follows:

	<b>As at December 31, 2009</b>
Debt host	<b>\$ 184,079</b>
Fair value of embedded derivatives	<b>358,272</b>
Interest payable	<b>4,712</b>
<b>Convertible debenture</b>	<b>\$ 547,063</b>
<b>Financial Statement Presentation</b>	
<b>CURRENT LIABILITIES</b>	
Current portion of convertible debenture	<b>\$ 4,712</b>
<b>NON-CURRENT LIABILITIES</b>	
Convertible debenture	<b>542,351</b>
<b>Convertible debenture</b>	<b>\$ 547,063</b>

# **SOUTHGOBI ENERGY RESOURCES LTD.**

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### **24. 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.

At December 31, 2009, the asset retirement obligations relate to reclamation and closure costs of the Company's Ovoot Tolgoi project in Mongolia.

The asset retirement obligations at Ovoot Tolgoi are calculated as the net present value of estimated future net cash outflows of the reclamation and closure costs, which at December 31, 2009 total \$3,449 and are required to satisfy the obligations, discounted at 10.78% per annum. The settlement of the obligations will occur through to 2024.

The following is an analysis of the asset retirement obligation:

Balance, as at December 31, 2007	\$	-
Additions		310
Accretion		19
Balance, as at December 31, 2008		329
Additions		366
Accretion		40
<b>Balance, as at December 31, 2009</b>	<b>\$</b>	<b>735</b>

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 25. SHARE CAPITAL

#### 25.1 Issued and outstanding capital

The Company has authorized an unlimited number of common and preferred shares with no par value. Below is an analysis in the movement of the issued and outstanding common and preferred shares.

	Common shares		Preferred shares	
	Number of shares	Amount	Number of shares	Amount
Balance, as at January 1, 2008	74,933	\$ 30,230	25,576	\$ 4,189
Shares issued for:				
Cash	16,211	139,642	-	-
Share issue costs	-	(3,303)	-	-
Mineral properties	322	5,198	-	-
Conversion of line of credit	14,709	107,552	-	-
Conversion of preferred shares	25,576	4,189	(25,576)	(4,189)
Exercise of stock options	1,442	6,004	-	-
Balance, as at December 31, 2008	133,193	\$ 289,512	-	\$ -
Shares issued for:				
Exercise of stock options	1,324	\$ 6,907	-	\$ -
<b>Balance, as at December 31, 2009</b>	<b>134,517</b>	<b>\$296,419</b>	<b>-</b>	<b>\$ -</b>

The weighted average share price during the year ended December 31, 2009 was Cdn\$12.09 (2008: Cdn\$11.15).

#### 25.2 Preferred shares

On May 29, 2007, upon completion of the coal transaction (Note 31), the Company issued 25,576 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 preferred shares into common shares of the Company on a one to one basis. The Company has no outstanding preferred shares at December 31, 2009.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### 26. SHARE-BASED PAYMENTS

#### 26.1 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 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.

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 year ended December 31, 2009 were granted with a weighted average maximum exercise period of 5.95 years (2008: 5.00 years) and a weighted average vesting period of 1.82 years (2008: 1.95 years).

During the year ended December 31, 2009, the Company granted 2,671 stock options (2008: 3,184) to officers, employees, directors and other eligible persons at exercise prices ranging from Cdn\$7.94 to Cdn\$14.25 (2008: Cdn\$5.10 to Cdn\$18.86) and expiry dates ranging from May 6, 2014 to February 6, 2016 (2008: January 7, 2013 to November 27, 2013). The weighted average fair value of the options issued in the year ended December 31, 2009, was estimated at \$5.95 (Cdn\$6.56) (2008: \$5.96, Cdn\$6.31) per option at the grant date using the Black-Scholes option pricing model. The weighted average assumptions used for the calculation were:

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Risk free interest rate	<b>2.17%</b>	2.81%
Expected life	<b>3.6 years</b>	3.5 years
Expected volatility <sup>(i)</sup>	<b>79.54%</b>	75.52%
Expected dividend per share	<b>\$nil</b>	\$nil

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

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 26. SHARE-BASED PAYMENTS (Continued)

#### 26.1 Stock option plan (continued)

A share-based compensation cost of \$14,872 for the options granted in the year ended December 31, 2009 (2008: \$17,623) will be amortized over the vesting period, of which \$5,125 was recognized in the year ended December 31, 2009 (2008: \$5,008).

The total share-based compensation calculated for the year ended December 31, 2009 was \$12,535 (2008: \$7,238). Share-based compensation of \$10,471 (2008: \$3,770) has been allocated to Administration expenses, \$1,590 (2008: \$540) has been allocated to Cost of sales and \$474 (2008: \$2,928) has been allocated to Evaluation and exploration expenses.

#### 26.2 Outstanding stock options

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

	Year ended December 31, 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 year	6,586	\$ 7.18	4,995	\$ 3.55
Options granted	2,671	11.13	3,184	11.27
Options exercised	(1,324)	3.16	(1,442)	2.80
Options forfeited	(679)	9.96	(151)	15.25
<b>Balance, end of year</b>	<b>7,254</b>	<b>\$ 9.11</b>	<b>6,586</b>	<b>\$ 7.18</b>

The following table summarizes information about stock options outstanding and exercisable at December 31, 2009:

Exercise price (Cdn\$)	Options Outstanding			Options Exercisable		
	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	902	\$ 2.16	1.45	902	\$ 2.16	1.45
\$3.70 - \$6.00	2,166	5.57	3.10	1,500	5.78	2.73
\$7.16 - \$13.80	3,270	11.21	4.55	498	10.68	4.13
\$15.07 - \$18.86	916	16.82	3.58	333	16.74	3.58
	<b>7,254</b>	<b>\$ 9.11</b>	<b>3.61</b>	<b>3,233</b>	<b>\$ 6.65</b>	<b>2.68</b>

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

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### **27. ACCUMULATED DEFICIT AND DIVIDENDS**

The Company has incurred losses since inception and at December 31, 2009 the Company has accumulated a deficit of \$321,511 (2008: \$213,323).

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

### **28. CAPITAL RISK MANAGEMENT**

The Company's objectives are to safeguard the Company's ability to continue as a going concern in order to support the Company's normal operating requirements, continue the development and exploration of its mineral properties and to maintain a flexible capital structure which optimizes the costs of capital at an acceptable risk.

The Company manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust the capital structure, the Company may issue new shares, issue new debt, acquire or dispose of assets or adjust the amount of cash and cash equivalents. In order to facilitate the management of its capital requirements, the Company prepares annual expenditure budgets that are updated as necessary depending on various factors, including capital deployment, results from operations, results from the exploration and development of its properties and general industry conditions. The annual and updated budgets are approved by the Board of Directors.

At December 31, 2009, the Company's capital structure consists of convertible debt (Note 23) and the equity of the Company (Note 25). The Company is not subject to any externally imposed capital requirements. In order to maximize ongoing development efforts, the Company does not pay dividends.

In the year ended December 31, 2009, there were no significant changes in the processes used by the Company's or in the Company's objectives and policies for managing its capital. The Company expects that based on the proceeds from the convertible debenture (Note 23) and the net proceeds from the international offering concluded in January 2010 (Note 35.1), sufficient capital resources are available to support further expansion and development of its mining assets.



# SOUTHGOBI ENERGY RESOURCES LTD.

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### 29. FINANCIAL INSTRUMENTS

Details of the significant accounting policies and methods adopted by the Company for each class of financial asset, financial liability and equity instrument are disclosed in Note 4 of the financial statements.

#### 29.1 Categories of financial instruments

The Company's financial assets and financial liabilities are categorized as follows:

	As at December 31, 2009	As at December 31,	
		2008	2007
<b>Financial assets</b>			
Loans and receivables			
Cash and cash equivalents	\$ 357,342	\$ 10,117	\$ 1,394
Trade and other receivables	12,328	7,290	760
Other receivables	225	-	-
Fair value through profit and loss			
Investment in Kangaroo Resources (Note 16)	9,876	-	-
Money market investments (Note 16)	62,193	-	-
<b>Total financial assets</b>	<b>\$ 441,964</b>	<b>\$ 17,407</b>	<b>\$ 2,154</b>
<b>Financial liabilities</b>			
Fair value through profit and loss			
Convertible debenture - embedded derivatives (Note 23)	\$ 358,272	\$ -	\$ -
Other financial liabilities			
Trade and other payables	12,669	7,400	1,768
Amounts due under line of credit facilities	3,009	-	105,673
Convertible debenture - debt host (Note 23)	188,791	-	-
Deposit received for sale of Metals Division	-	3,000	-
<b>Total financial liabilities</b>	<b>\$ 562,741</b>	<b>\$ 10,400</b>	<b>\$ 107,441</b>

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

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### **29. FINANCIAL INSTRUMENTS (Continued)**

#### **29.2 Fair value**

The fair value of financial assets and financial liabilities at amortized cost is determined in accordance with generally accepted pricing models based on discounted cash flow analysis or using prices from observable current market transactions. The Company considers that the carrying amount of all its financial assets and financial liabilities recognized at amortised cost in the financial statements approximates their fair value.

The fair values of the Company's financial instruments classified as FVTPL are determined as follows:

- The fair value of financial instruments that are traded on an active liquid market are determined with reference to the quoted market prices. The fair value of the Company's investment in the shares of KRL and its money market investments was determined using this methodology.
- The fair value of financial instruments that are not traded in an active market are determined using generally accepted valuation models using inputs that are directly (i.e. prices) or indirectly (i.e. derived from prices) observable. The fair value of the embedded derivatives within the convertible debenture (Note 23) was determined using a Monte Carlo simulation. None of the fair value change on the embedded derivatives for the year ended December 31, 2009 is related to a change in the credit risk of the convertible debenture. All of the change in fair value is associated with changes in market conditions.

The fair value of all the other financial instruments of the Company approximates their carrying value because of the demand nature or short-term maturity of these instruments.

The following table provides an analysis of the Company's financial instruments that are measured subsequent to initial recognition at fair value, grouped into Level 1 to 3 based on the degree to which the inputs used to determine the fair value are observable.

- Level 1 fair value measurements are those derived from quoted prices in active markets for identical assets or liabilities.
- Level 2 fair value measurements are those derived from inputs other than quoted prices included within Level 1, that are observable either directly or indirectly.
- Level 3 fair value measurements are those derived from valuation techniques that include inputs that are not based on observable market data. As at December 31, 2009, the Company does not have any Level 3 financial instruments.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 29. FINANCIAL INSTRUMENTS (Continued)

#### 29.2 Fair value (continued)

	As at December 31, 2009		
	Level 1	Level 2	Total
<b>Financial assets at FVTPL</b>			
Investment in Kangaroo Resources	\$ 9,876	\$ -	\$ 9,876
Money market investments	62,193	-	62,193
<b>Total financial assets at FVTPL</b>	<b>\$ 72,069</b>	<b>\$ -</b>	<b>\$ 72,069</b>
<b>Financial liabilities at FVTPL</b>			
Convertible debenture - embedded derivatives	\$ -	\$ 358,272	\$ 358,272

There were no transfers between Level 1 and 2 in the year ended December 31, 2009.

#### 29.3 Financial risk management objectives and policies

The financial risk arising from the Company's operations are currency risk, interest rate risk, credit risk, liquidity risk and commodity price risk. These risks arise from the normal course of operations and all transactions undertaken are to support the Company's ability to continue as a going concern. The risks associated with these financial instruments and the policies on how to mitigate these risks are set out below. Management manages and monitors these exposures to ensure appropriate measures are implemented on a timely and effective manner.

##### Currency risk

The Company's borrowings, major operating expenses and acquisition costs are denominated in U.S. dollars and a minor portion of the expenses of the Company are in Canadian dollars. The Company's corporate office is based in Canada and the exposure to exchange rate fluctuations arise mainly on foreign currencies against the functional currency of the relevant Company entities which is the U.S. dollar. The Company does not have any significant foreign currency denominated monetary liabilities.

The Company has not entered into any derivative instruments to manage foreign exchange fluctuations; however, management monitors foreign exchange exposure.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 29. FINANCIAL INSTRUMENTS (Continued)

#### 29.3 Financial risk management objectives and policies (continued)

The carrying amounts of the Company's foreign currency denominated monetary assets are as follows:

	As at December 31, 2009	As at December 31,	
		2008	2007
<b>Assets</b>			
Canadian Dollar	\$ (136)	\$ 3,872	\$ 225
Hong Kong Dollars	262	-	\$ -
Mongolian Tugriks	53	104	6
Indonesian Rupiah	-	15	52
	<b>\$ 179</b>	<b>\$ 3,991</b>	<b>\$ 283</b>

#### *Foreign currency sensitivity analysis*

The following table details the Company's sensitivity to a 5% increase or decrease in the U.S. dollar against the foreign currency denominated monetary items in the preceding table. 5% represents management's assessment of the reasonable possible change in foreign exchange rates. The sensitivity analysis includes only outstanding foreign currency denominated monetary items and adjusts their translation at the end of the period for a 5% change in foreign currency rates. A positive number indicates a decrease in loss for the year where the foreign currencies strengthen against the U.S. dollar. The opposite number will result if the foreign currencies depreciate against the U.S. dollar.

	As at December 31, 2009	As at December 31,	
		2008	2007
<b>Decrease in</b>			
Loss for the year	<b>\$ 9</b>	<b>\$ 200</b>	<b>\$ 14</b>

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 29. FINANCIAL INSTRUMENTS (Continued)

#### 29.3 Financial risk management objectives and policies (continued)

##### Interest rate risk

The Company is exposed to interest rate risk on the variable rate of interest earned on some of its short and long term money market investments. The fair value interest rate risk on cash and cash equivalents is insignificant as the deposits are either short-term or pay interest at rates of 1.0% or less.

The Company has not entered into any derivative instruments to manage interest rate fluctuations, however, management closely monitors interest rate exposure and the risk exposure is limited.

##### *Interest rate sensitivity analysis*

The following table details the Company's sensitivity to a 50 basis points increase or decrease in the interest rate earned on the Company's money market investments with floating rates of return. 50 basis points represents management's assessment of the reasonable possible change in earned interest rates. The sensitivity analysis assumes the financial instruments outstanding at the end of each reporting period were outstanding throughout the whole year. A positive number indicates an increase in the loss for the year where the interest rate has decreased, while the opposite number will result if the interest rate increased. In prior periods, the Company was exposed to interest rate risk on debt where interest was incurred at a variable rate, at December 31, 2009, the Company has no such debt. In prior periods, the Company had conducted the sensitivity analysis on floating rate debt assuming a 500 basis point increase in the interest rate incurred.

	As at December 31, 2009	As at December 31,	
		2008	2007
<b>(Decrease)/increase in:</b>			
Loss for the year	\$ (87)	\$ -	\$ 1,718

##### Credit risk

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its contractual obligations. Credit risk for the Company is primarily associated with trade receivables, value added tax ("VAT") receivable, goods and services tax ("GST") receivable and cash equivalents and short and long term money market investments.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

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### **29. FINANCIAL INSTRUMENTS (Continued)**

#### **29.3 Financial risk management objectives and policies (continued)**

The credit risk on trade receivables is managed through an internal process whereby any potential customer is investigated before a sales contract is signed. Risk is further mitigated as the payment terms for all customers range from 10 days to 14 days, which allows the Company to actively monitor the amounts owed by customers and identify any credit risks in a timely manner and reduce the risk of a credit related loss. In addition, the Company reviews the recoverable amount of its receivables at the end of each reporting period to ensure that adequate impairment losses are made for unrecoverable amounts. In this regard, the Company considers that the credit risk associated with trade receivables is significantly reduced.

The VAT/GST receivable includes amounts that have been accumulated to date in various subsidiaries. At December 31, 2009, 98% of the VAT/GST receivable was due from the Mongolian Government Taxation Authority. As per Mongolia tax laws, a tax payer may offset future taxes and royalties payable to the Government against VAT amounts receivable from the Government. In the fourth quarter of 2009, based on a request from the Mongolian tax office, the Company was requested to reclass \$3,111 from VAT receivable to prepaid taxes to offset future current income tax payments. In the year ended December 31, 2009, the Company also offset current income taxes owing of \$509 against its VAT receivable balance. In July 2009, the Mongolia Tax Laws were amended to preclude producers and exporters of unfinished mineral products from claiming back VAT. The Mongolian Government has yet to define what products will qualify as finished mineral products and any VAT amounts impacted will be prospective from the effective date of the law, August 16, 2009. Based on currently available information, the Company anticipates full recoverability of amounts due on account. Verification by the Mongolian Government Taxation Authority of the collectability of the funds is conducted on an annual basis and any outstanding VAT receivable amounts at December 31, 2009, except those possibly impacted by the law change, will be available to the Company to offset future taxes and royalties or will be refunded by the Mongolian Government Taxation Authority.

The credit risk on cash equivalents is limited because the cash equivalents and short and long term money market investments are composed of money market investments issued by banks and other institutions with high credit ratings as assigned by international credit-rating agencies.

The Company is not exposed to significant credit risk and overall the Company's credit risk has not changed significantly during the year ended December 31, 2009.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 29. FINANCIAL INSTRUMENTS (Continued)

#### 29.3 Financial risk management objectives and policies (continued)

##### Liquidity risk

Liquidity risk is the risk that the Company will not be able to settle or manage its obligations associated with financial liabilities. In the management of liquidity risk, the Company maintains a balance between continuity of funding and the flexibility through the use of borrowings. Management closely monitors the liquidity position and expects to have adequate sources of funding to finance the Company's projects and operations. The directors of the Company are of the opinion that, taking into account the Company cash reserves and external financial resources, the Company has sufficient working capital for its present obligations, that is for at least the next twelve months commencing from December 31, 2009.

The following table details the Company's and the Company's expected remaining contractual maturities for its financial liabilities with agreed repayment periods. The table is based on the undiscounted cash flows of financial liabilities based on the earliest date on which the Company can be required to satisfy the liabilities.

	0 to 6 months	6 to 12 months	1 to 5 years	Total
<b>As at December 31, 2007</b>				
Trade and other payables	\$ 1,768	\$ -	\$ -	\$ 1,768
Amounts due under line of credit facilities <sup>(i)</sup>	-	-	24,095	24,095
	<u>\$ 1,768</u>	<u>\$ -</u>	<u>\$ 24,095</u>	<u>\$ 25,863</u>
<b>As at December 31, 2008</b>				
Trade and other payables	\$ 7,400	\$ -	\$ -	\$ 7,400
	<u>\$ 7,400</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 7,400</u>
<b>As at December 31, 2009</b>				
Trade and other payables	\$ 12,669	\$ -	\$ -	\$ 12,669
Amounts due under line of credit facilities	170	3,206	-	3,376
Convertible debenture - cash interest (Note 23)	-	21,874	64,000	85,874
	<u>\$ 12,839</u>	<u>\$ 25,080</u>	<u>\$ 64,000</u>	<u>\$ 101,919</u>

(i) Amount shown at amortized cost using a weighted average interest rate of 6.7%

# SOUTHGobi ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 29. FINANCIAL INSTRUMENTS (Continued)

#### 29.3 Financial risk management objectives and policies (continued)

##### Commodity price risk

Profitability of the Company depends on the coal prices it is able to realize. Coal prices are affected by numerous factors such as interest rates, exchange rates, inflation or deflation and global and regional supply and demand.

The Company enters into sales contracts with its customers to manage the risk of a significant decrease in the price of coal. The Company has not entered into any coal hedging instruments to manage its exposure to fluctuations in coal prices. As coal sales are the only source of revenue for the Company, a 5% increase or decrease in coal prices will result in a corresponding increase or decrease in revenue.

### 30. RELATED PARTY TRANSACTIONS

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

Name	Country of incorporation	% equity interest		
		As at	As at December 31,	
		December 31, 2009	2008	2007
Asia Gold International Holding Company Ltd.	British Virgin Islands	100%	100%	100%
SouthGobi Energy Resources (Hong Kong) Ltd.	Hong Kong	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%
PT Multi Mamahak Batubara	Indonesia	-	85%	-
Arkadia Indonesia Holding Company Ltd.	British Virgin Islands	-	100%	100%
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%
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 Batubara (A) Pte. Ltd.	Singapore	-	85%	-
SGQ Indonesia Holding Company Pte. Ltd.	Singapore	-	100%	100%
SGQ Mongolia Holding Ltd.	Singapore	-	100%	100%
SGQ Singapore Investment Company Pte. Ltd.	Singapore	-	100%	100%
SGQ Singapore Projects Holding Company Pte. Ltd.	Singapore	-	100%	100%



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## Notes to the Consolidated Financial Statements

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### 30. RELATED PARTY TRANSACTIONS (Continued)

#### 30.1 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 December 31, 2009, Ivanhoe owned approximately 79% of the outstanding common shares of the Company. Below is an analysis of the Company's related party expenses:

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Corporate administration	\$ 1,176	\$ 1,893
Salaries and benefits	1,321	1,824
Interest (Note 22)	1,642	134
<b>Total related party expenses</b>	<b>\$ 4,139</b>	<b>\$ 3,851</b>

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:

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
GMM	\$ 1,844	\$ 2,455
Ivanhoe	1,787	134
I2MS	508	1,262
<b>Total related party expenses</b>	<b>\$ 4,139</b>	<b>\$ 3,851</b>

#### 30.2 Related party assets

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

	<b>As at December 31, 2009</b>	<b>As at December 31,</b>	
		<b>2008</b>	<b>2007</b>
Amounts due from GMM	\$ 225	\$ -	\$ -

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 30. RELATED PARTY TRANSACTIONS (Continued)

#### 30.3 Related party liabilities

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

	As at December 31, 2009	As at December 31,	
		2008	2007
Amounts due to GMM	\$ 240	\$ 231	\$ 211
Accounts payable to Ivanhoe	158	61	52
Accounts payable to I2MS	211	285	-
Deposit received for sale of Metals Division	-	3,000	-
Amounts due under line of credit facilities	-	-	105,673
<b>Total liabilities due to related parties</b>	<b>\$ 609</b>	<b>\$ 3,577</b>	<b>\$ 105,936</b>

### 31. 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 common shares and 25,576 preferred shares of the Company.

On August 8, 2006, the Coal Transaction and the equity conversion rights under the line of credit facility (Note 22) 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.

# SOUTHGOBI ENERGY RESOURCES LTD.

## Notes to the Consolidated Financial Statements

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### 31. COAL TRANSACTION (Continued)

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 the Company, are approximately \$13.2 million of which \$13 million are related to exploration expenses and \$200 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 of the financial statements provides detailed disclosure of the impact of the principles of merger accounting.

### 32. KEY MANAGEMENT PERSONNEL COMPENSATION

The remuneration of directors and other members of key management were as follows:

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Short-term benefits	\$ 1,820	\$ 1,361
Share-based payments	5,425	2,504
<b>Total remuneration</b>	<b>\$ 7,245</b>	<b>\$ 3,865</b>

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

### **33. SUPPLEMENTAL CASH FLOW INFORMATION**

#### **33.1 Non-cash financing and investing activities**

The Company incurred the following non-cash investing and financing transactions:

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Conversion of line of credit facility (first funding agreement) (Note 22)	\$ -	\$ 107,552
Conversion of preferred shares to common shares	-	4,189
Acquisition of mineral properties through the issue of common shares	-	5,198
Transfer of share option reserve upon exercise of options	3,010	1,960
Acquisition of shares of KRL (Note 6.1)	8,776	-
<b>Total non-cash financing and investing activities</b>	<b>\$ 11,786</b>	<b>\$ 118,899</b>

#### **33.2 Cash payments for interest and taxes**

The Company made the following cash payments for interest and income taxes:

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Interest paid	\$ 1,642	\$ 77
Taxes paid	-	-
<b>Total cash payments for interest and taxes</b>	<b>\$ 1,642</b>	<b>\$ 77</b>

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Notes to the Consolidated Financial Statements**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### **34. COMMITMENTS FOR EXPENDITURE**

As at December 31, 2009, the Company had the following commitments that have not been disclosed elsewhere in the Consolidated Financial Statements:

	<b>As at December 31, 2009</b>				<b>Total</b>
	<b>Within 1 year</b>	<b>2-3 years</b>	<b>4-5 Years</b>	<b>Over 5 years</b>	
Capital expenditure commitments	<b>\$ 17,563</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 17,563</b>
Minimum rental and lease payments	<b>1,352</b>	<b>2,014</b>	<b>578</b>	<b>-</b>	<b>3,944</b>
<b>Commitments</b>	<b>\$ 18,915</b>	<b>\$ 2,014</b>	<b>\$ 578</b>	<b>\$ -</b>	<b>\$ 21,507</b>

### **35. SUBSEQUENT EVENTS**

#### **35.1 International offering**

On January 29, 2010, the Company successfully completed an international offering of 27,000 shares for gross proceeds of \$437,446. The Company incurred underwriter fees of \$17,415 and other share issue costs in association with the international offering. Simultaneously with the international offering the Company's shares began trading on the HKEX under the ticker HKEX: 1878.

#### **35.2 CIC conversion**

On March 12, 2010, the Company announced, subject to regulatory approval, a formal request for CIC to convert \$250,000 of its convertible debenture (Note 23) into common shares of the Company.

### **36. APPROVAL OF THE FINANCIAL STATEMENTS**

The Consolidated Financial Statements of SouthGobi Energy Resources Ltd. for the year ended December 31, 2009 were approved and authorized for issue by the Board of Directors on March 22, 2010.

# **SOUTHGOBI ENERGY RESOURCES LTD.**

## **Appendix to the Annual Report**

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### **ADDITIONAL STOCK EXCHANGE INFORMATION**

Additional information required by the Hong Kong Stock Exchange and not shown elsewhere in this report is as follows:

#### **A1. LOSS FOR THE YEAR**

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Loss for the year has been arrived at after charging:		
Auditor's remuneration	<b>\$ 198</b>	\$ 286
Loss on disposal of property, plant and equipment	<b>245</b>	6
Depreciation		
Depreciation included in administration expenses	<b>19</b>	98
Depreciation included in exploration expenses	<b>23</b>	92
Depreciation included in cost of sales	<b>5,814</b>	304
Total depreciation included in continuing operations	<b>5,856</b>	494
Depreciation included in discontinued operations	<b>-</b>	55
<b>Total depreciation</b>	<b>\$ 5,856</b>	<b>\$ 549</b>
Staff costs		
Directors' emoluments (Note A2)	<b>\$ 3,344</b>	\$ 2,219
Other staff costs	<b>10,660</b>	3,381
Retirement benefit costs excluding directors	<b>20</b>	18
Staff costs in administration expenses	<b>14,024</b>	5,618
Staff costs included in exploration expenses	<b>198</b>	3,338
<b>Total staff costs</b>	<b>\$ 14,222</b>	<b>\$ 8,956</b>

# SOUTHGOBI ENERGY RESOURCES LTD.

## Appendix to the Annual Report

December 31, 2009

(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)

### ADDITIONAL STOCK EXCHANGE INFORMATION (Continued)

#### A2. DIRECTOR AND EMPLOYEE EMOLUMENTS

##### Directors' emoluments

	Year ended December 31, 2009	Year ended December 31, 2008
Directors' fees	\$ 330	\$ 213
Other emoluments for executive and non-executive directors		
Salaries and other benefits <sup>(i)</sup>	372	255
Stock-based compensation	2,633	1,745
Retirement benefit contribution	8	8
<b>Directors' emoluments</b>	<b>\$ 3,343</b>	<b>\$ 2,221</b>

(i) Peter Meredith was awarded a bonus of \$50 and Alexander Molyneux was awarded a bonus of \$315 in light of their activities leading to the successful listing of the Company's shares on the HKEX and related equity financing. For Alexander Molyneux only \$103 of the bonus is included herein representing the proportion of time served as a director.

Name of director	Directors' fees	Salaries and other benefits	Stock-based compensation	Retirement benefit contribution	Total
<b>Year ended December 31, 2009</b>					
Peter Meredith	\$ -	\$ 191	\$ 661	\$ -	\$ 852
Alexander Molyneux <sup>(i)</sup>	-	181	522	-	703
John Macken	-	-	332	-	332
Pierre Lebel	104	-	229	2	335
André Deepwell	77	-	225	2	304
R. Edward Flood	29	-	228	1	258
R. Stuart (Tookie) Angus	61	-	218	2	281
Robert Hanson	59	-	218	1	278
	<b>\$ 330</b>	<b>\$ 372</b>	<b>\$ 2,633</b>	<b>\$ 8</b>	<b>\$ 3,343</b>

##### Year ended December 31, 2008

Peter Meredith	\$ -	\$ 255	\$ 647	\$ 1	\$ 903
John Macken	-	-	325	-	325
Pierre Lebel	65	-	165	3	233
André Deepwell	48	-	140	2	190
R. Edward Flood	18	-	156	-	174
R. Stuart (Tookie) Angus	42	-	156	2	200
Robert Hanson	40	-	156	-	196
	<b>\$ 213</b>	<b>\$ 255</b>	<b>\$ 1,745</b>	<b>\$ 8</b>	<b>\$ 2,221</b>

(i) Alexander Molyneux was appointed as a director and the CEO of the Company on October 11, 2009

# SOUTHGOBI ENERGY RESOURCES LTD.

## Appendix to the Annual Report

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

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### ADDITIONAL STOCK EXCHANGE INFORMATION (Continued)

#### A2. DIRECTOR AND EMPLOYEE EMOLUMENTS (Continued)

##### Five highest paid individuals

The five highest paid individuals included two directors of the Company for the years ended December 31, 2009 and 2008. The emoluments of the remaining three highest paid individuals for the years ended December 31, 2009 and 2008 are as follows:

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
Salaries and other benefits	\$ 695	\$ 893
Retirement benefit contribution	2	6
Stock-based compensation	1,738	759
	<b>\$ 2,435</b>	<b>\$ 1,658</b>

Their emoluments were within the following bands:

	<b>Year ended December 31, 2009</b>	<b>Year ended December 31, 2008</b>
HK\$ 3,000,001 to HK\$ 3,500,000	-	2
HK\$ 5,000,001 to HK\$ 5,500,000	1	-
HK\$ 6,000,001 to HK\$ 6,500,000	1	1
HK\$ 7,500,001 to HK\$ 8,000,000	1	-
	<b>3</b>	<b>3</b>

During the years ended December 31, 2009 and 2008, no emoluments were paid by the Company to the directors or the five highest paid individuals as an inducement to join or upon joining the Company or as compensation for loss of office. None of the directors of the Company has waived any emoluments during the years ended December 31, 2009 and 2008.



# SOUTHGOBI ENERGY RESOURCES LTD.

## Appendix to the Annual Report

December 31, 2009

*(expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)*

### ADDITIONAL STOCK EXCHANGE INFORMATION (Continued)

#### A3. FIVE YEAR SUMMARY

Below is a five year summary of the Company's results, assets and liabilities:

	Year ended December 31, 2009	Year ended December 31,			
		2008	2007	2006	2005
Revenue	\$ 36,038	\$ 3,126	\$ -	\$ -	\$ -
Income from mine operations	6,613	949	-	-	-
Net loss and comprehensive loss attributable to equity holders of the Company	\$ (110,805)	\$ (69,576)	\$ (96,736)	\$ (21,729)	\$ (16,110)
Basic and diluted loss per share from continuing and discontinued operations	(0.83)	(0.54)	(1.89)	(1.31)	(1.06)

  

	As at December 31, 2009	As at December 31,			
		2008	2007	2006	2005
Total assets	\$ 560,684	\$ 99,948	\$ 5,610	\$ 2,315	\$ 3,919
Less: Total liabilities	(563,476)	(10,984)	(107,441)	(6,287)	(914)
Total net (liabilities)/assets	\$ (2,792)	\$ 88,964	\$ (101,831)	\$ (3,972)	\$ 3,005