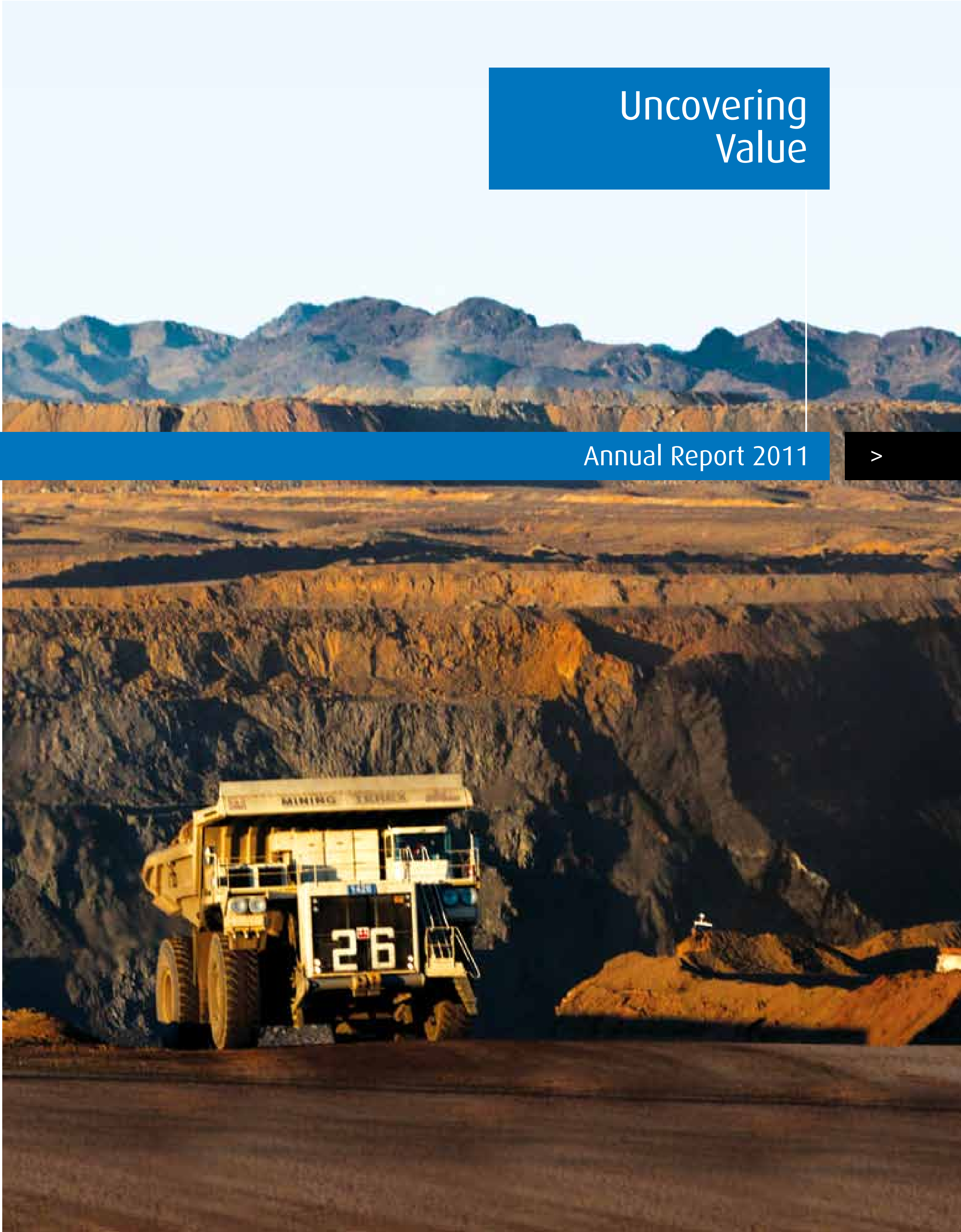
SouthGobi Resources

Uncovering Value



Annual Report 2011

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Contents

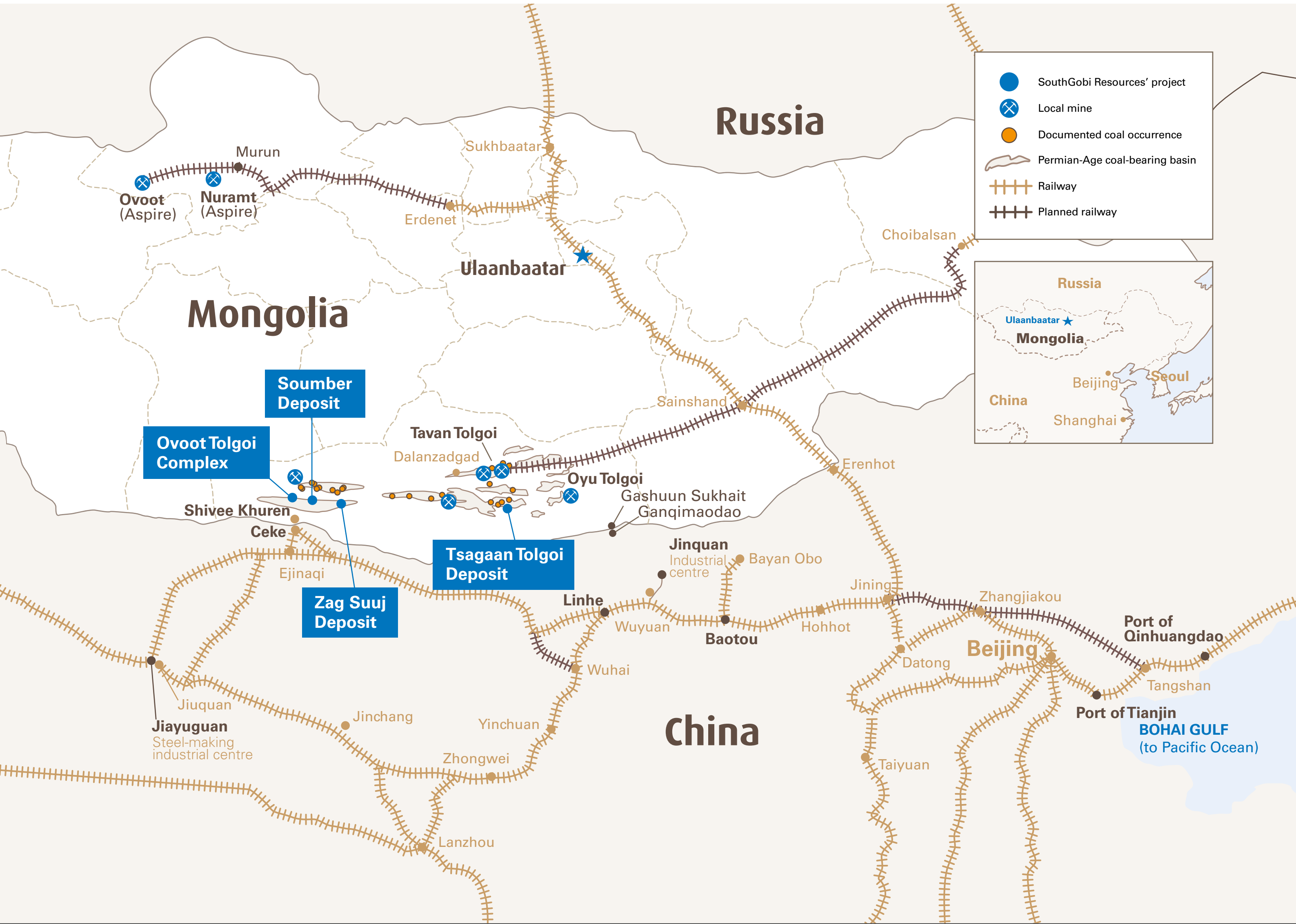
SouthGobi Resources Ltd. (the "Company" or "SouthGobi") is focused on the acquisition, exploration, development and production of its Permian-age metallurgical and thermal coal deposits in Mongolia's South Gobi Region.

The Company's flagship coal mine, Ovoot Tolgoi, is producing and selling coal to customers in China. SouthGobi Resources plans to supply a wide range of coal products to markets in Asia.

Highlights

The Company's highlights for the year ended December 31, 2011 and subsequent weeks are as follows:

- Record annual coal sales of approximately 4.02 million tonnes (increase of 58% from 2010);
- Record annual gross profit of US$51.7 million (increase of 424% from 2010);
- Record annual revenue of US$179.0 million (increase of 124% from 2010);
- Coal production of 4.57 million tonnes compared to 2.79 million tonnes in 2010, continuing to demonstrate the successful ramp-up of operations at the Company's Ovoot Tolgoi Mine;
- Average realized selling price of US$54.03 per tonne (increase of 56% compared to 2010);
- On July 5, 2011, SouthGobi entered into an agreement with Ejinaqi Jinda Coal Industry Co. Ltd ("Ejin Jinda") to wet wash coal from the Ovoot Tolgoi Mine on a tolling arrangement;
- On July 6, 2011, SouthGobi received a mining license pertaining to the Soumber Deposit, subsequent exploration in 2011 has expanded its resource base;
- Awarded the tender to construct a paved highway from the Ovoot Tolgoi Mine to the Shivee Khuren-Ceke crossing at the Mongolia-China border ("Shivee Khuren Border Crossing") with consortium partner NTB LLC;
- On February 13, 2012, SouthGobi successfully commissioned its dry coal handling facility ("DCHF") at the Ovoot Tolgoi Mine;
- On March 5, 2012, SouthGobi announced an agreement to sell the Tsagaan Tolgoi Deposit to Modun Resources Limited ("Modun") for expected consideration of US$30.0 million;
- Increased NI 43-101 compliant coal reserves estimate for the Ovoot Tolgoi Mine by 65% to 176 million tonnes; and
- Increased NI 43-101 compliant measured and indicated coal resources estimate by 35% to 492 million tonnes and inferred coal resources estimate by 42% to 244 million tonnes.



Closest coal to China >

Our reserves and resources

Below is a summary of the Company's reserves and resources (expressed in million of tonnes):

Reserves

Area	Proven	Probable	Total
Ovoot Tolgoi Mine	119	57	176

Resources

Area	Measured	Indicated	Total measured and Indicated	Inferred
Ovoot Tolgoi Mine	133	60	193	24
Ovoot Tolgoi Underground	66	43	109	62
Soumber	58	79	137	83
Tsagaan Tolgoi	23	13	36	9
Zag Suuj	0	17	17	66
Total Resources	**280**	**212**	**492**	**244**

Strategically located close to China

Approximately 40km to China and transportation infrastructure

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>> Closest coal to China

>> Rail access at Chinese border

>> Benefitting from improved logistics in China and market dynamics

China is the largest importer of met coal

Short-haul to China infrastructure and transportation approximately

40km

New border gates at Shivee Khuren/Ceke crossing to be operational in 2012

Rail facilities at Ceke

Premium quality coals

>> Processing to improve quality and value of our coal

>> Dry coal handling facility commissioned in February 2012

>> Contract with wet wash plant at Ceke to process higher ash coals

Increasing quality and value of coking coals >

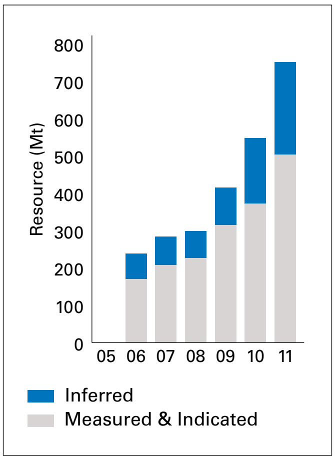
Coal processing facilities

Wet wash plant at Ceke

Dry coal handling facility at Ovoot Tolgoi

Exploration edge

Historical resource growth



Total exploration costs 2005–2011 of approximately US$

115m

Equates to US$

0.16 /tonne[1]

resources discovered

A track record for increasing resources

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SouthGobi's resources derive from our aggressive in-house exploration program. The Company began exploration in the Ovoot Khural Basin in 2005, and has identified 492 million tonnes of measured and indicated resources and 244 million tonnes of inferred resources. As a result of our successful exploration program, our average finding cost is a mere US$0.16/tonne[1].

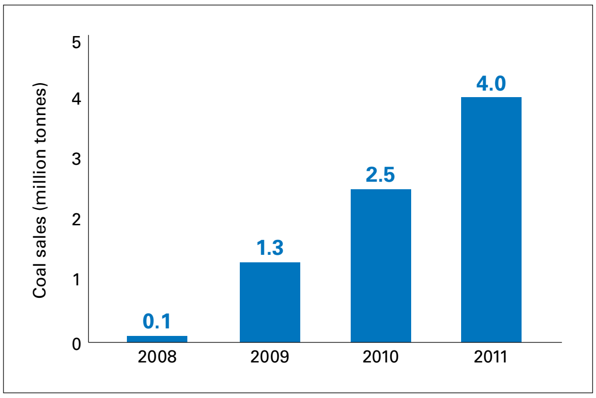
We expect our resource base to grow even further as we continue exploring our exploration licenses and further define our known deposits.

1 Based on the Company's total resources which includes 492 million tonnes of measured and indicated resources and 244 million tonnes of inferred resources


MSA

Sustainable volume growth

SouthGobi coal sales growth



>> Ovoot Tolgoi continued expansion

- Full/steady state production 9.0 Mtpa
- Annual sales 7.3-7.9 Mtpa

>> Soumber hard coking coal

- Received mining license pertaining to the Soumber Deposit in July 2011
- Resources increased in 2011
- Reserve study being completed

>> Growth from resource development / Underground

- Additional drilling and resource definition
- Potential for additional production in several years

Focused on sales growth

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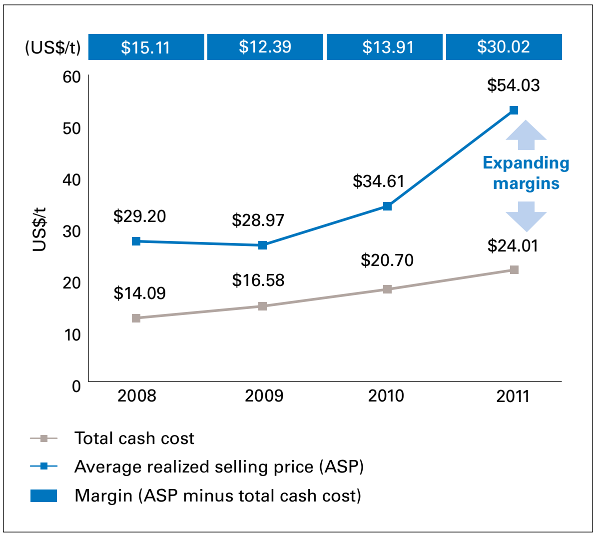
Expanding margins

>> Sources of future margin expansion

- Improved infrastructure efficiency
- Sales mix improvement
- Washed coal vs. raw coal at Ovoot Tolgoi
- Introduction of premium hard coking coal at Soumber Deposit

Margins continue to increase >

Margin per tonne



Commitment to the community

>> Commitment focused on responsible economic growth, environment, human capital and community

>> Created Corporate Citizenship Committee to ensure strategy is implemented

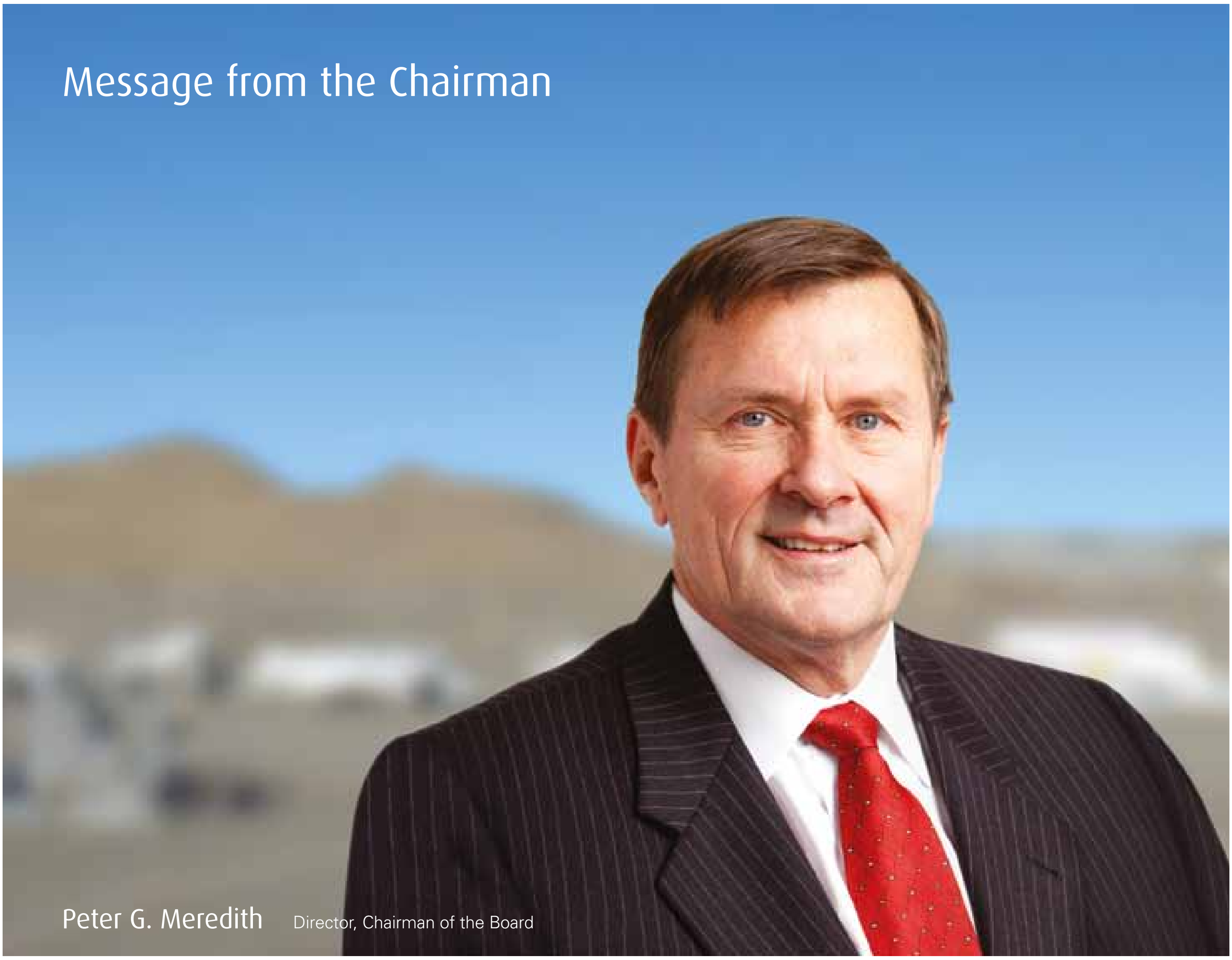
Turning good intentions into effective results >

Corporate social responsibility strategy and delivery

SouthGobi worked with local school children to collect seeds for use in reclamation activities

SouthGobi donated a 100 student kindergarten to Gurvantes soum, providing school for children and employment for 10 teachers and staff

Message from the Chairman



Peter G. Meredith Director, Chairman of the Board

Each year, I have been honored and privileged to introduce the continuing successes that have been achieved by SouthGobi Resources. I am proud to note that 2011 was another year of achievement. We have just written yet another chapter in the ongoing story of SouthGobi's emergence as one of Asia's significant coal producers.

This year, we set new production records, solidified our core strategy and continued fulfilling our commitments to our employees and the communities in which we operate. Among 2011's new records:

- Annual coal sales hit a company high of 4.02 million tonnes – a 58% increase from 2010. Mongolia continues to be the largest exporter of coal to China, thanks in part to the men and women of SouthGobi. As we continue expanding our production capacity, we will continue to remain at the forefront of Mongolia's coal trade with China.
- Annual revenue was US$179.0 million – up 124% from the previous year. This was due to a combination of increased sales and higher pricing. As Mongolian coal exports to China expand and become more liquid, and as China continues to build its rail network, SouthGobi will be better positioned to realize higher prices for its coal. Our average realized selling price reached US$54.03 per tonne during 2011 – an increase of 56% over last year.
- Annual gross profit was a record US$51.7 million – an annual increase of 424%. Our continued focus on increasing production, expanding our customer base, improving coal quality and controlling costs is yielding increased gross profits.

Of course, any discussion about our Company's growth and record numbers necessarily involves acknowledgement of the significance of our quality Mongolian coking coal resources. We made considerable progress during 2011 toward our objective of extracting full value from our leadership position in the Ovoot Khural Basin in Mongolia's South Gobi Region. We increased production at the Ovoot Tolgoi Mine to 4.57 million tonnes, a large jump of 64%, or 1.78 million tonnes, over our 2010 performance. In February 2012, we announced the commissioning of our dry coal handling facility at the mine site, which is the next step in our strategy to enhance the quality and value of our coals.

We also conducted a very successful exploration campaign in 2011. In March 2012 we announced that our measured and indicated resources increased by 129 million tonnes and we added another 72 million tonnes of inferred resources. We now have a total of 492 million tonnes of measured and indicated resources and 244 million tonnes of inferred resources, primarily in the Ovoot Khural Basin.

As part of our continuing, long-range strategy to develop key infrastructure to support our mine developments, we and our consortium partner, NTB LLC, were awarded a contract to build a paved coal-haul highway to transport coal from our Ovoot Tolgoi Mine to the Shivee Khuren-Ceke crossing at the Mongolia-China border. This world class coal-haul highway will provide a safer, more cost effective route to connect with shipment facilities across the border and to our customers in China.

We reached an important milestone in July when we received a mining licence for our Soumber Deposit. Subsequent exploration has expanded Soumber's resources inside and outside the area covered by the mining licence, and as reported in March 2012, increasing the measured and indicated resources by 124% to 137 million tonnes and raising the inferred resources by 26% to 83 million tonnes of low-to-medium volatile bituminous coal. We also have issued a maiden resource report in March 2012 for a new deposit, Zag Suuj, approximately 150 kilometres east of Ovoot Tolgoi.

In March 2012, we announced an agreement to sell the Tsagaan Tolgoi Deposit to Modun Resources Limited for an expected consideration of US$30.0 million in cash and shares in Modun. The structure of this deal ensures that SouthGobi will retain continued exposure to Tsagaan Tolgoi and new exposure to Modun's other attractive projects in Mongolia, while at the same time allowing us to concentrate on the development of our core Ovoot Khural Basin resources.

SouthGobi continues to maintain its active commitments to our employees in the fields of health, safety and career development, and to support the communities in which we operate. During 2011, we provided nearly 52,000 employee-hours of safety training. We also signed an agreement with a local vocational training school in the regional capital, Dalanzadgad, to provide initial vocational training for employees. Our Lost-Time Injury Frequency Rate was 0.8, keeping us within the standards of world-class coal mining operations. We added 176 new jobs in 2011, finishing the year with 720 employees. More than 97% of our employees in Mongolia are Mongolian nationals, and more than 52% were from the local soums (districts) around our Ovoot Tolgoi operation.

In the broader community, we signed a memorandum of understanding with the South Gobi Province to formalize cooperation between the Company and the local government. We are proud that the kindergarten for 100 students in Gurvantes, sponsored by the Company, was opened in 2011. We continued to provide winter assistance, including the provision of livestock feed for local herders and coal for winter heating in several local communities. More than 20 students received full scholarships from SouthGobi to help them continue their education at Mongolian universities. Upon graduation, they will be granted internships at SouthGobi to begin their professional careers.

SouthGobi had another banner year. The Board of Directors is pleased to be working with our entire team on behalf of all the stakeholders of the Company as we set about writing the next chapter in SouthGobi's remarkable story.

Peter G. Meredith
Director, Chairman of the Board

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Message from the President and CEO

Objectives for 2012

The Company's objectives for 2012 continue the theme of our 2011 objectives, as follows:

>> Grow Ovoot Tolgoi Mine

In 2011 we increased sales by 58% over 2010 to 4.02 million tonnes and increased production by 64% over 2010 to 4.57 million tonnes. In 2012 SouthGobi aims to finalize the commissioning of two additional mining fleets (one Liebherr 996 excavator based and one Liebherr R9250 excavator based). The additional capacity of the new mining fleets should support growth in coal availability and sales for 2012 over 2011.

Alexander Molyneux President and Chief Executive Officer

Q: How did SouthGobi perform against the objectives you set out last year?

A: In 2011 we generally met the primary objectives we identified for ourselves. We had record production and sales, identified over 129 million tonnes in additional measured and indicated resources and 72 million tonnes of inferred resources and continued to operate safely and cost effectively.

Q: What do you see as the key highlights of SouthGobi?

A: First is our strategic location, only approximately 40 km from China and very close to the Chinese rail system. Our resources are premium quality coking coals including semi-soft and hard coking coals. The Company is also going through a process of improving its current sales mix through introduction of beneficiation. SouthGobi has sustainable volume growth through continued expansion of our Ovoot Tolgoi mine and development of additional properties.

Q: How are the operations at Ovoot Tolgoi doing?

A: We are pleased with our Ovoot Tolgoi operations. Through our continued success in mining there, in 2011 we had record volumes (both production and sales), record margins and recorded a substantial gross profit. Furthermore, our Lost-Time Injury Frequency Rate for 2011 of 0.8 was below our target of 2, and at a world class level.

Q: SouthGobi started as an exploration company, and now has its flagship Ovoot Tolgoi Mine in operation. Is exploration still important?

A: Absolutely. Last year we significantly increased the resources in our Soumber Deposit, and we also announced the maiden resource for our new Zag Suuj Deposit. We will continue to be an 'exploration company' in 2012.

>> Continue to develop regional infrastructure

The upgrade of the road from the mine to the local soum center of Gurvantes was completed in 2011, providing safer and easier travel for the mine and the local community. The Company's immediate priority centers on improving roads in the area around the Ovoot Tolgoi Mine. SouthGobi is part of a consortium awarded the tender to construct a paved highway from Ovoot Tolgoi to the Mongolia-China border. The consortium intends to imminently commence construction of the highway that is expected upon completion to have a carrying capacity in excess of 20 million tonnes of coal per year.

>> Advancing the Soumber Deposit

As a result of the exploration program in 2011, the NI 43-101 compliant resources at Soumber were significantly increased, adding 76 million tonnes of measured and indicated resources for a total of 137 million tonnes and adding 17 million tonnes of inferred resources, for a total of 83 million tonnes. SouthGobi intends to further define the deposit with continued exploration work while also substantially advancing the feasibility and planning for a mine at Soumber.

>> Value-adding/upgrading coal

The Company is committed to continue progress toward improving the quality and value of the coal we sell. The dry coal handling facility at Ovoot Tolgoi was commissioned in February 2012. Ejin Jinda is close to commissioning its wet washing facility to process some SouthGobi coals close to the Mongolia-China border on a toll washing arrangement.

>> Exploration

SouthGobi had a very successful exploration program in 2011, adding 129 million tonnes of measured and indicated resources, for a total of 492 million tonnes and adding 72 million tonnes of inferred resources, for a total of 244 million tonnes, including the maiden resource report for the Zag Suuj Deposit. In 2012, exploration will take place to further define the Company's existing deposits.

>> Operations

The Company had a very successful year in the areas of production safety, environmental protection, operational excellence and community relations. We will continue to focus on these areas.

Q: Will SouthGobi require funding for its aggressive growth over the next 5-10 years?

A: At this time we believe we can fund our growth plans with the cash and marketable securities we currently have, and the cash we will continue to generate from our operations.

Q: SouthGobi sells all its coal to China. Is the market strong enough to support your projected growth?

A: The forecast for China's met coal imports vary, but all show a significant rise over the next decade. Mongolia in general and SouthGobi in particular with our location only approximately 40 km from China are best positioned to supply a variety of coking coals to China. The growth in China will support continued growth of the met coal industry in Mongolia and we are confident of sufficient market for all our projected growth.

Q: What coal products does SouthGobi sell?

A: Our Ovoot Tolgoi operation has been selling raw coal with the primary product being a raw semi-soft coking coal. With the introduction of beneficiation, the majority of Ovoot Tolgoi's salable production will be in the form of clean semi-soft coking coal. Our Soumber Deposit is expected to produce hard coking coals. Although we haven't completed full testing yet, the Zag Suuj Deposit also appears to be a high quality coking coal.

Q: Are there any other comments you want to share?

A: SouthGobi made significant progress in 2011. We achieved record production and sales, and record gross profit of US$51.7 million; an increase of 424% from 2010. This year will be another milestone year in terms of seeing financial gain on the significant investments we've made over the last several years. I am proud of the team we have at SouthGobi, and firmly believe we will have a banner year in 2012.

Board of directors

Peter Meredith

Chairman of the Board, Non-Executive Director

Mr. Meredith, 68, joined the Company as a Non-Executive Director on August 13, 2003. He was the Chief Executive Officer of the Company from June 2007 to October 2009, and Chairman of the Board since October 2009. He has served as the Deputy Chairman of Ivanhoe Mines Ltd., the Company's principal shareholder, since May 2006, overseeing Ivanhoe's business development and corporate relations. Prior to assuming the position of Deputy Chairman, Mr. Meredith was Ivanhoe's CFO from May 2004 to May 2006 and from June 1999 to November 2001. Mr. Meredith spent 31 years with Deloitte and Touche LLP, Chartered Accountants, and retired as a partner in 1996.

Mr. Meredith is a Chartered Accountant and is a member of the Institute of Chartered Accountants of British Columbia, the Institute of Chartered Accountants of Ontario and the Ordre des Comptables Agréés du Québec. Mr. Meredith is a member of the Institute of Corporate Directors.

Alexander Molyneux

President and Chief Executive Officer, Director

Mr. Molyneux, 37, joined the Company as President on April 27, 2009 and is based in Hong Kong. On October 11, 2009, he was given the additional responsibilities of Chief Executive Officer and appointed as a Director. Prior to joining the Company Mr. Molyneux was Managing Director, Head of Metals & Mining Investment Banking, Asia Pacific, with Citigroup. In this position he spent approximately 10 years providing specialist advice and investment banking services to mining and industrial corporations, including extensive involvement in coal-related transactions. Mr. Molyneux has advised on coal-related public offerings, mergers and acquisitions, bond and debt offerings totalling several billion dollars. He joined Citigroup from UBS in early-2007 as Head of Metals & Mining Investment Banking.

Mr. Molyneux holds a Bachelor degree in Economics from Monash University in Australia and is a member of the Institute of Corporate Directors.

Pierre Lebel

Independent Non-Executive Director and Lead Director

Mr. Lebel, 62, joined the Company as an Independent Non-Executive Director on August 13, 2003. Mr. Lebel is the Company's Lead Director and served as its Chairman from 2003 until June 2007. He has a distinguished career in mining spanning over 30 years, with a primary focus on mine financing, construction and development. Mr. Lebel currently serves as Chairman and a Director of Imperial Metals Corporation, a TSX-listed mine developer and operator. In 1998, Mr. Lebel was awarded the E.A. Scholz Medal by the BC and Yukon Chamber of Mines for excellence in mine development in British Columbia.

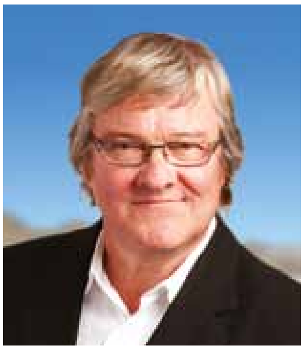
Mr. Lebel holds a Masters of Business Administration from McMaster University and a Bachelor of Laws (LLB) from the University of Western Ontario. He is a member of the Law Societies of British Columbia and Alberta. He is also a member of the Board of Directors of the Mining Association of Canada, the Mining Association of Canada and a member of the Institute of Corporate Directors.

André Deepwell

Independent Non-Executive Director

Mr. Deepwell, 57, joined the Company as an Independent Non-Executive Director on August 13, 2003. He has been the Chief Financial Officer and Corporate Secretary of a number of natural resource companies over the last fifteen years and is currently Chief Financial Officer and Corporate Secretary of Imperial Metals Corporation, a TSX-listed mine developer and operator. Mr. Deepwell has been involved in all aspects of debt and equity financings and financial reporting for mining enterprises ranging from grassroots exploration to mine development and production.

Mr. Deepwell is a Chartered Accountant, certified by the Institute of Chartered Accountants of British Columbia, and a graduate of the University of British Columbia. He is a member of the Institute of Corporate Directors.



R. Stuart (Tookie) Angus

Independent Non-Executive Director

Mr. Angus, 63, joined the Company as an Independent Non-Executive Director on May 25, 2007. Mr. Angus is an independent consultant to the mining industry and has over 35 years experience advising companies in the mineral resources industry. Previously, he was Managing Director – Mergers and Acquisitions with Endeavour Financial Corporation, which provides financial advisory services to the mining and minerals industries. Prior to joining Endeavour Financial in 2003, he was a senior partner in the law firm, Fasken Martineau DuMoulin, as head of its Global Mining Group.

Mr. Angus holds a Bachelor of Laws (LLB) from the University of British Columbia and is a retired member of the Law Society of British Columbia. He is a member of the Institute of Corporate Directors. Mr. Angus does not plan to stand for re-election at the 2012 Annual General Meeting.

Robert Hanson

Independent Non-Executive Director

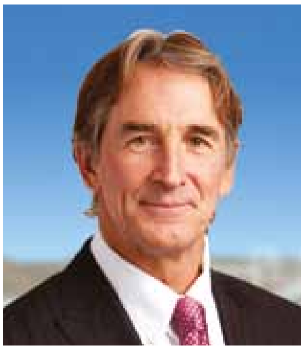
Mr. Hanson, 51, joined the Company as an Independent Non-Executive Director on May 25, 2007. He is the Chairman of Hanson Capital Investments Limited, Strand Hanson Ltd., Hanson Family Holdings Ltd. and Hanson Asset Management Ltd. He is also Managing Partner of Millennium Hanson Internet Partners. He was Chairman of Hanson Westhouse Limited from February 1998 to April 2009 and an Associate Director of N.M. Rothschild & Sons from 1983 to 1990, serving in London, Hong Kong, Chile and Spain. From 1990 to 1997, he served on the Board of Directors of Hanson PLC, responsible for strategy, mergers and acquisitions transactions.

Mr. Hanson was educated at Eton and received his Master of Arts in English Language & Literature from St Peter's College, Oxford. He is a trustee of the Hanson Foundation and a founding trustee of the Raisa Gorbachev Foundation fighting child cancers. He is a member of the Institute of Corporate Directors.

John Macken
Non-Executive Director

Mr. Macken, 60, joined the Company as a Non-Executive Director on June 25, 2007. He was the Company's Chairman from June 2007 to October 2009. He joined Ivanhoe Mines Ltd., the Company's principal shareholder, in 2003 and is its President. Mr. Macken was Ivanhoe's Chief Executive Officer from May 2006 to October 2010. He has been a member of Ivanhoe's Executive Committee since its formation in March 2005. Prior to joining Ivanhoe, Mr. Macken spent 19 years with Freeport McMoran Copper and Gold, most recently as Freeport's Senior Vice-President of Strategic Planning and Development.

Mr. Macken holds a Bachelor of Arts and a Bachelor of Arts in Engineering (Hons.) from Trinity College at Dublin University in Ireland. He is a Chartered Engineer certified by the Institute of Engineers in Ireland and was a Professional Engineer certified by the Province of Ontario, Canada.



R. Edward Flood
Independent Non-Executive Director

Mr. Flood, 66, joined the Company as an Independent Non-Executive Director on August 13, 2003. He was its interim President and Chief Executive Officer from August 2006 to June 2007. He is the Chairman and Chief Executive Officer of Concordia Resource Corp. (formerly Western Uranium Corporation), a mineral exploration corporation with a focus on uranium. He has been a Director of Ivanhoe Mines Ltd., the Company's principal shareholder, since its founding in 1994 and was also its President from founding until May 1999. Mr. Flood served as Deputy Chairman of Ivanhoe Mines Ltd. until February 2007, assisting in developing Ivanhoe's growth and its establishment as a significant presence in Asia's mineral exploration and mining sectors. Mr. Flood also held the position of senior mining analyst with Haywood Securities Inc. from 1999 to 2001, and Managing Director, Investment Banking, Haywood Securities (UK) Ltd. from March 2007 to March 2010.

Mr. Flood holds a Masters of Science in Geology from the University of Montana and a Bachelor in Science in Geology from the University of Nevada. He is a member of the Institute of Corporate Directors.

W. Gordon Lancaster
Independent Non-Executive Director

Mr. Lancaster, 68, joined the Company as an Independent Non-Executive Director on May 11, 2010. He is currently an independent business consultant. Mr. Lancaster was Chief Financial Officer of Ivanhoe Energy Inc., an international heavy-oil development and production company whose core operations are in Canada, Ecuador and China. Prior to joining Ivanhoe Energy Inc. in 2004, he was Chief Financial Officer of Power Measurement Inc., a Victoria-based high-tech company that is a world leader in the design, development, manufacture and marketing of enterprise energy management systems.

Mr. Lancaster is a Chartered Accountant certified by the Institute of Chartered Accountants of British Columbia and, prior to entering industry in 1982, he had a twenty year career in public accounting with Deloitte & Touche with the last five years as a partner in that firm's Vancouver office. He is a member of the Institute of Corporate Directors.

Senior management

Matthew O'Kane
Chief Financial Officer

Mr. O'Kane, 41, joined the Company in January 2011 as Vice President, Commercial Operations and Investor Relations and was promoted to Chief Financial Officer on July 1, 2011. Prior to joining the Company, Mr. O'Kane spent over four years as the Finance Director and an Executive Director with Volvo Car Australia Pty Ltd, a fully owned subsidiary of Volvo Car Corporation Sweden. Mr. O'Kane has over 16 years in finance roles within the manufacturing industry and has worked for Ford Motor Company both in Australia and in the United States.

Mr. O'Kane holds a Bachelor degree in Business in Economics and Finance and a Masters of Business Administration from the Royal Melbourne Institute of Technology, and is a qualified Certified Practicing Accountant.

Curtis Church
Chief Operating Officer

Mr. Church, 39, became the Company's Chief Operating Officer on March 15, 2011, having joined the Company on January 14. 2008. Since joining the Company, Mr. Church has also held the title of Vice-President, Mining Operations and was General Manager of the Ovoot Tolgoi coal mine for more than two years. Mr. Church has over 18 years' experience in the mineral resources industry, including more than six years of experience working at mining operations in Mongolia.

In August 2011, Mr. Church received the Altan Gadas award (Order of the Polar Star) from Mongolia in recognition of his contribution to developing the mining sector in Mongolia and bilateral cooperation between Mongolia and Canada in the field of mining.

Dave Bartel
Vice President, Investor Relations and External Affairs

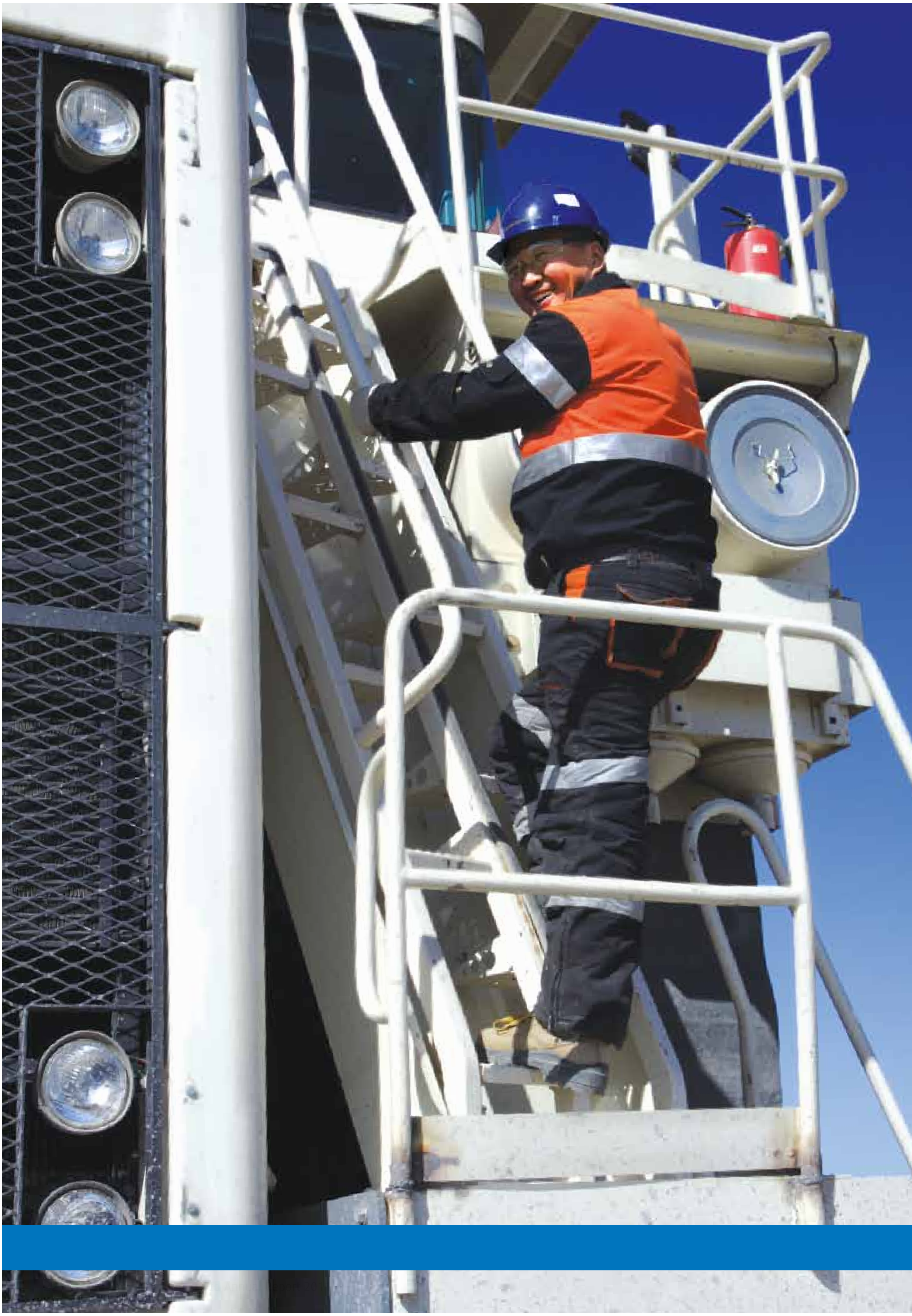
Mr. Bartel, 54, joined the Company on January 1, 2007 as the Manager of Engineering for SouthGobi Sands. He was promoted to the General Manager of SouthGobi Sands in November 2007, Vice President of Mongolian Operations and President of SouthGobi Sands LLC in September 2009 and to his present position in April 2011. He has over 30 years' experience in the mineral resources industry. He was formerly an independent consultant and a project manager to the coal and other mining industries with Wiley Consulting LLC. He held various positions including Chief Engineer and Director of Environmental and Engineering Services for the Coal Division of Entech Inc., the non-regulated arm of Montana Power Co., and various subsidiaries of that company. He was a mining engineer for Phillips Coal Co. and for Utah International Co.

Mr. Bartel received his Bachelor of Science in Mining Engineering with High Honors from the Colorado School of Mines in 1979. He is a Registered Professional Engineer in the states of Colorado, Montana and Arkansas.

Tony Pearson
Vice President, Corporate Development

Mr. Pearson, 37, joined the Company in his current position in February 2010. Mr. Pearson previously held senior positions with the Australian Securities & Investments Commission, Citigroup's Metals and Mining Investment Banking team and Westpac Banking Corporation. During his time with Citigroup, Mr. Pearson advised mining clients on capital raisings, mergers, acquisitions and divestitures, with particular responsibility for Asian and Australian mining companies. Mr. Pearson is also a non-executive director of Aspire Mining Ltd.

Mr. Pearson received a Bachelor of Commerce with Merit from the University of New South Wales in 1996.



Directors' report

The Board of Directors (the "Board") of SouthGobi Resources Ltd. is pleased to present their report along with the audited consolidated financial statements (the "Financial Statements") of SouthGobi Resources Ltd. together with its subsidiaries (collectively the "Company") for the Financial Year ended December 31, 2011 ("Financial Year").

Principal activities and geographical analysis of operations

The principal activities of the Company are the acquisition, exploration, development and production of coal properties. The Company's principal subsidiaries are set out in Note 27 of the Consolidated Financial Statements and the activities of the principal subsidiaries of the Company at December 31, 2011 are set out in the table below:

Name	Country of incorporation	Issued and fully paid share capital	Principal activities
SouthGobi Resources (Hong Kong) Ltd.	Hong Kong	HK$1	Business services
Dayarbulag LLC	Mongolia	MNT 12,120,000	Investment holding
SouthGobi Sands LLC	Mongolia	MNT 11,655,000	Coal mining, development and exploration of properties in Mongolia
SGQ Coal Investment Pte. Ltd.	Singapore	US$1	Investment holding
SGQ Dayarcoal Mongolia Pte. Ltd.	Singapore	US$1	Investment holding

The analysis of the principal activities by geographical location of the operations of the Company for the Financial Year is set out in Note 4 of the Consolidated Financial Statements.

Results

The results of the Company for the Financial Year are set out in the Consolidated Statement of Comprehensive Income on page 94.

Dividends

The Board has not recommended, declared or paid any dividends for the Financial Year.

Property, plant and equipment

Details of the movement in the property, plant and equipment of the Company during the Financial Year are set out in Note 16 of the Consolidated Financial Statements.

Share capital

Details of the movement in the share capital of the Company during the Financial Year are set out in the Consolidated Statement of Changes in Equity on page 96.

During the Financial Year the Company repurchased its own shares on the Toronto Stock Exchange and Hong Kong Stock Exchange. Details of the shares repurchased are set out on page 140. The Board believes the Company has adequate financial resources combined with anticipated income from its mining operations for its current growth requirements and believes the shares of the Company have been undervalued.

Reserves

Details of the reserves available for distribution to the shareholders as at December 31, 2011 are set out in the Consolidated Statement of Changes in Equity on page 96.

Directors

The directors during the Financial Year and up to the date of this report are as follows:

Executive Directors

Mr. Alexander Molyneux

Non-Executive Directors

Mr. Peter Meredith *(Chairman)*
Mr. John Macken

Independent Non-Executive Directors

Mr. Pierre Lebel *(Lead Director)*
Mr. André Deepwell
Mr. R. Stuart (Tookie) Angus
Mr. Robert Hanson
Mr. R. Edward Flood
Mr. W. Gordon Lancaster

The term of office for each of the directors will end at the conclusion of the forthcoming annual general meeting. Each of the directors offers themselves for re-election at the annual general meeting scheduled for May 17, 2012. Mr. Angus has indicated he does not plan to stand for re-election at the 2012 annual general meeting.

In accordance with article 14.1 of the articles of continuation for the Company, each of the directors, including the independent non-executive directors, are subject to retirement and re-election annually at the annual general meeting.

Directors' service contracts

None of the directors proposed for re-election at the forthcoming annual general meeting has a service contract with the Company which is not determinable by the Company within one year without payment of compensation, other than statutory compensation.

Directors' interests in contracts of significance

No contracts of significance to which the Company was a party and in which a director of the Company had a material interest, whether directly or indirectly, subsisted at December 31, 2011 or at any time during the Financial Year.

Directors' interests in competing businesses

During the Financial Year and up to the date of this report, to the best knowledge of the directors, none of the directors had any interests in businesses that compete or are likely to compete, either directly or indirectly, with the Company.

Directors' and senior management's interests in shares and share options

At December 31, 2011, the interests of the directors and certain executive officers including: Matthew O'Kane, the Chief Financial Officer, Terry Krepiakevich, the former Chief Financial Officer, Curtis Church, the Chief Operating Officer, Dave Bartel, the Vice President of Investor Relations and External Affairs and Tony Pearson, the Vice President of Corporate Development, in the shares and share options of the Company and its associated corporations were as follows:

Shares

Name	Name of company	Nature of interest	Shares held	Approximate % interest in the company
Peter Meredith	SouthGobi Resources Ltd	Direct/indirect	10,000	0.01%
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
Alexander Molyneux	SouthGobi Resources Ltd	Personal	22,500	0.01%
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
Pierre Lebel	SouthGobi Resources Ltd	Personal	5,100	0.00%
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
André Deepwell	SouthGobi Resources Ltd	Direct/indirect	45,000	0.02%
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
R. Stuart (Tookie) Angus	SouthGobi Resources Ltd	N/A	Nil	Nil
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
Robert Hanson	SouthGobi Resources Ltd	Direct/indirect	12,500	0.01%
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
John Macken	SouthGobi Resources Ltd	N/A	Nil	Nil
	Ivanhoe Mines Ltd.	Personal	276,748	0.04%
R. Edward Flood	SouthGobi Resources Ltd	N/A	Nil	Nil
	Ivanhoe Mines Ltd.	Personal	23,766	0.00%
W. Gordon Lancaster	SouthGobi Resources Ltd	N/A	Nil	Nil
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
Matthew O'Kane	SouthGobi Resources Ltd	N/A	Nil	Nil
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
Terry Krepiakevich	SouthGobi Resources Ltd	Personal	50	0.00%
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
Curtis Church	SouthGobi Resources Ltd	Personal	5,900	0.00%
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
Dave Bartel	SouthGobi Resources Ltd	Personal	1,668	0.00%
	Ivanhoe Mines Ltd.	N/A	Nil	Nil
Tony Pearson	SouthGobi Resources Ltd	N/A	Nil	Nil
	Ivanhoe Mines Ltd.	N/A	Nil	Nil

Shares Options

Name	Name of company	Number of options held
Peter Meredith	SouthGobi Resources Ltd	745,000
	Ivanhoe Mines Ltd.	2,731,770
Alexander Molyneux	SouthGobi Resources Ltd	1,350,000
	Ivanhoe Mines Ltd.	68,732
Pierre Lebel	SouthGobi Resources Ltd	230,000
	Ivanhoe Mines Ltd.	Nil
André Deepwell	SouthGobi Resources Ltd	200,000
	Ivanhoe Mines Ltd.	Nil
R. Stuart (Tookie) Angus	SouthGobi Resources Ltd	150,000
	Ivanhoe Mines Ltd.	Nil
Robert Hanson	SouthGobi Resources Ltd	150,000
	Ivanhoe Mines Ltd.	63,928
John Macken	SouthGobi Resources Ltd	446,000
	Ivanhoe Mines Ltd.	5,901,407
R. Edward Flood	SouthGobi Resources Ltd	150,000
	Ivanhoe Mines Ltd.	124,526
W. Gordon Lancaster	SouthGobi Resources Ltd	185,000
	Ivanhoe Mines Ltd.	Nil
Matthew O'Kane	SouthGobi Resources Ltd	420,000
	Ivanhoe Mines Ltd.	Nil
Terry Krepiakevich	SouthGobi Resources Ltd	400,000
	Ivanhoe Mines Ltd.	22,481
Curtis Church	SouthGobi Resources Ltd	695,000
	Ivanhoe Mines Ltd.	Nil
Dave Bartel	SouthGobi Resources Ltd	380,500
	Ivanhoe Mines Ltd.	Nil
Tony Pearson	SouthGobi Resources Ltd	350,000
	Ivanhoe Mines Ltd.	Nil

Other than the holdings disclosed in the preceding table, none of the directors, senior management and their associates had any interests or short positions in any shares, underlying shares or debentures of the Company or of its associated corporations as at December 31, 2011.

Management contracts

No contracts concerning the management and administration of the Company were entered into or existed during the Financial Year.

Share option scheme

The particulars of the Company's share option scheme are set out in Note 22 of the Financial Statements.

The following table discloses movements in the Company's share options for the Financial Year:

Name	Outstanding at beginning of year	Granted during the year	Exercised during the year	Forfeited during the year	Expired during the year	Outstanding at year end
Peter Meredith	685,000	60,000	–	–	–	745,000
Alexander Molyneux	950,000	400,000	–	–	–	1,350,000
Pierre Lebel	225,000	40,000	(35,000)	–	–	230,000
André Deepwell	200,000	35,000	(35,000)	–	–	200,000
R. Stuart (Tookie) Angus	115,000	35,000	–	–	–	150,000
Robert Hanson	115,000	35,000	–	–	–	150,000
John Macken	411,000	35,000	–	–	–	446,000
R. Edward Flood	115,000	35,000	–	–	–	150,000
W. Gordon Lancaster	150,000	35,000	–	–	–	185,000
Matthew O'Kane	–	420,000	–	–	–	420,000
Terry Krepiakevich	400,000	–	–	–	–	400,000
Curtis Church	395,000	300,000	–	–	–	695,000
Dave Bartel	305,500	100,000	(25,000)	–	–	380,500
Tony Pearson	250,000	100,000	–	–	–	350,000
Total for directors and senior management	4,316,500	1,630,000	(95,000)	–	–	5,851,500
Total for other share option holders	4,959,025	1,862,500	(647,534)	1,257,527	–	4,916,464
Total	**9,275,525**	**3,492,500**	**(742,534)**	**1,257,527**	**–**	**10,767,964**

Arrangement to purchase shares and debentures

In addition to the option holdings disclosed above, Messrs Molyneux, Meredith, Church and Bartel participate in the Company's share purchase plan, which allows the Company's employees to contribute up to 7% of their basic annual salary to purchase shares in the Company. The Company contributes 50% of the employee's contribution and at the end of each calendar quarter shares are purchased on behalf of the employee. As at March 14, 2012, Messrs Pearson and O'Kane joined the Company's share purchase plan.

Substantial shareholders

The register of interests in shares and short positions of the Company showed that as at December 31, 2011, the Company has been notified of the following interests in shares representing 10% or more of the Company's issued share capital:

Name	Natural of interest	Shares held	Approximate percentage of issued shares
Ivanhoe Mines Ltd.	Beneficial	104,807,155	58%
China Investment Corporation	Beneficial	25,017,908	14%

Other than as disclosed above, the Company has not been notified of any relevant interests or short positions in the issued share capital of the Company as at December 31, 2011.

Emolument policy

The emolument policy of the executives of the Company is administered by the Compensation and Benefits Committee on the basis of merit, qualifications and competence and approved by the Board. The emolument policy for the rest of the employees is determined on a department-by-department basis with the executive in charge of each department determining the emoluments for senior employees and managers in the department and the emoluments for non-senior employees being determined by an appropriately designated manager. The emolument policy for non-executives is administered in conjunction with the human resources department and is done on the basis of merit, qualifications and competence.

The emolument policy for the directors of the Company is administered by the Compensation and Benefits Committee and approved by the Board, having regard to comparable market statistics.

The Company also has a share option plan as incentive to the Company's directors and eligible employees. Details of the plan are set out in Note 22 of the Consolidated Financial Statements.

Pre-emptive rights

There are no provisions for pre-emptive rights under the Company's articles of continuation or under the laws of Canada which would oblige the Company to offer new shares on a pro-rata basis to existing shareholders.

Sufficiency of public float

The requirement that a prescribed percentage of shares of any class of listed securities must at all times be held by the public does not apply to the Company.

Major customers and suppliers

Details of the Company's transactions with its major suppliers and customers during the Financial Year are set out below:

Purchases

The largest supplier accounted for 40% of the Company's purchases.

The five largest suppliers accounted for 55% of the Company's purchases.

Sales

The largest customer accounted for 46% of the Company's sales.

The five largest customers accounted for 98% of the Company's sales.

At no time during the Financial Year did a director, an associate of a director or a shareholder of the Company (which to the knowledge of the directors owns more than 5% of the Company's share capital) have an interest in any of the Company's five largest suppliers or five largest customers.

Charitable donations

During the Financial Year the Company made charitable donations amounting to US$618,000.

Events after reporting period

On March 5, 2012, the Company entered into an agreement to sell its thermal coal property, the Tsagaan Tolgoi Deposit, to Modun, a company listed on the Australian Stock Exchange. Under the transaction, the Company expects to receive US$30.0 million of total consideration, comprising US$7.5 million up-front in cash, US$12.5 million up-front in Modun common shares and deferred consideration of an additional US$10.0 million, also payable in Modun common shares.

Independent auditor

A resolution will be submitted at the annual general meeting to appoint PricewaterhouseCoopers as auditors of the Company.

On behalf of the Board

Peter Meredith
Director, Chairman of the Board
March 19, 2012

Corporate governance report

Corporate governance

The Board of Directors considers good corporate governance practices to be an important factor in the continued and long-term success of the Company which will help to maximize shareholder value over time.

To further this philosophy and ensure the Company follows good governance practices, the Board has taken the following steps:

- approved and adopted a mandate for the Board;
- appointed an independent non-executive director, as "Lead Director", with specific responsibility for maintaining the independence of the Board and ensuring the Board carries out its responsibilities contemplated by applicable statutory and regulatory requirements and stock exchange listing standards;
- appointed an Audit Committee, a Nominating and Corporate Governance Committee, a Compensation and Benefits Committee and a Mergers and Acquisitions Committee consisting solely of independent non-executive directors;
- established a Health, Environment, Safety and Social Responsibility Committee;
- approved charters for the Audit, Nominating and Corporate Governance and Compensation and Benefits Committees;
- established a management Disclosure Committee for the Company, with the mandate to oversee the Company's disclosure practices including the establishment of a sub-committee charged with overseeing the Company's technical disclosure;
- formalized the Company's Corporate Disclosure, Confidentiality and Securities Trading Policy, and Disclosure Controls and Procedures;
- adopted a formal Code of Business Conduct and Ethics and companion booklet for the Company that governs the behavior of directors, officers and employees and which is also distributed to consultants;
- adopted formalized written position descriptions for the Chairperson, Lead Director, CEO, CFO, and chairs of the Audit, Compensation and Benefits, and Nominating and Corporate Governance committees, clearly defining their respective roles and responsibilities;
- adopted a whistleblower policy administered by an independent third party;
- Directors and Senior Management of the Company have completed a Foreign Corrupt Practices Act training program;
- formalized a process for assessing the effectiveness of the Board as a whole, the committees of the Board and the contribution of individual directors, on a regular basis; and
- adopted an executive compensation model for the Company.

Compliance with corporate governance

The Company has, throughout the Financial Year, applied the principles and complied with the requirements of its corporate governance practices as defined by the Board and all applicable statutory, regulatory and stock exchange listings standards. The Company's current practices are reviewed and updated regularly to ensure that the latest developments in corporate governance are followed and observed.

Board composition

Corporate governance guidelines adopted by the Canadian Securities Administrators ("CSA") recommend that a majority of the directors of a corporation be independent directors. Under the CSA corporate governance guidelines, an "independent director" is a director who has no direct or indirect material relationship with the Company, including as a partner, shareholder or officer of an organization that has a relationship with the Company. A "material relationship" is one that would, or in the view of the Board could be reasonably expected to, interfere with the exercise of a director's independent judgment. The Board believes that as at December 31, 2011 and as at the date of this report, six of its nine directors are "independent directors" under the CSA corporate governance guidelines.

As at March 19, 2012, the Board has determined that it consists of six independent non-executive directors and three non-independent Directors, as follows:

Independent non-executive directors	Non-independent directors
Mr. Pierre Lebel *(Lead Director)*	Mr. Alexander Molyneux *(President and Chief Executive Officer)* (1)
Mr. André Deepwell	Mr. Peter Meredith *(Chairman)* (2)
Mr. R. Stuart (Tookie) Angus	Mr. John Macken (2)
Mr. Robert Hanson	
Mr. R. Edward Flood	
Mr. W. Gordon Lancaster	

Notes:

(1) Mr. Molyneux is a non-independent director in his capacity as a senior officer of the Company.

(2) Messrs. Macken and Meredith, executive officers of Ivanhoe, are considered to be non-independent directors as a result of the material relationship between the Company and Ivanhoe, and in the case of Mr. Meredith, as a former member of management of the Company.

As at March 19, 2012, Ivanhoe held approximately 58% of the Company's issued and outstanding common shares. The Board has determined that the Company currently has six of nine directors in Messrs. Lebel, Deepwell, Angus, Hanson, Flood and Lancaster who are independent of Ivanhoe. The Board has determined that over half of its directors do not have an interest in or relationships with either the Company or its principal shareholder and which fairly reflects the investment in the Company by shareholders other than the principal shareholder.

The directors are satisfied with the size and composition of the Board and believe that the current board composition results in a balanced representation among management and non-management directors, and the Company's major shareholder. While the Board functions effectively given the Company's stage of development and the size and complexity of its business, the Board, through its Nominating and Corporate Governance Committee, will continue to seek qualified candidates to augment its experience and expertise and to enhance the Company's ability to effectively develop its business interests.

Mr. Meredith currently serves as Chairman of the Board and from June 2007 to October 2009 was the Chief Executive Officer of the Company. Mr. Molyneux was appointed as Chief Executive Officer of the Company on October 11, 2009. The Board is of the view that appropriate structures and procedures are in place to allow the Board to function independently of management while continuing to provide the Company with the benefit of having a Chairman of the Board with extensive experience and knowledge of the Company's business.

The Board has created the position of Lead Director, with specific responsibility for maintaining the independence of the Board and ensuring that the Board carries out its responsibilities. Mr. Lebel has served as the Company's Lead Director since 2007. Mr. Lebel does not serve in a similar capacity with any other company.

The Company has received from each of the independent non-executive directors, the respective confirmation of independence pursuant to listing rules in all applicable jurisdictions. The Company considers all the named independent non-executive directors as independent.

To the best knowledge of the Company, none of the directors of the Company are related. Relationships include financial, business or family relationships. Each director is free to exercise their independent judgment.

Mandate of the board

Under the British Columbia Business Corporations Act ("BCBCA"), the directors of the Company are required to manage the Company's business and affairs, and in doing so to act honestly and in good faith with a view to further the best interests of the Company. In addition, each director must exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. The Board is responsible for supervising the conduct of the Company's affairs and the management of its business. The Board's mandate includes setting long-term goals and objectives for the Company, formulating the plans and strategies necessary to achieve those objectives and supervising senior management in their implementation. Although the Board delegates the responsibility for managing the day-to-day affairs of the Company to senior management personnel, the Board retains a supervisory role in respect of, and ultimate responsibility for, all matters relating to the Company and its business.

The Board's mandate requires that the Board be satisfied that the Company's senior management will manage the affairs of the Company in the best interest of the shareholders, in accordance with the Company's principles, and that the arrangements made for the management of the Company's business and affairs are consistent with their duties described above. The Board is responsible for protecting shareholder interests and ensuring that the incentives of the shareholders and of management are aligned. The obligation of the Board must be performed continuously, and not merely from time to time, and in times of crisis or emergency the Board may have to assume a more direct role in managing the affairs of the Company.

In discharging this responsibility, the Board's mandate provides that the Board oversees and monitors significant corporate plans and strategic initiatives. The Board's strategic planning process includes annual budget reviews and approvals, and discussions with management relating to strategic and budgetary issues.

As part of its ongoing review of business operations, the Board periodically reviews the principal risks inherent in the Company's business, including financial risks, through periodic reports from management of such risks, and assesses the systems established to manage those risks. Directly and through the Audit Committee, the Board also assesses the integrity of internal controls over financial reporting and management information systems.

In addition to those matters that must, by law, be approved by the Board, the Board is required under its mandate to approve annual operating and capital budgets, any material dispositions, acquisitions and investments outside of the ordinary course of business or not provided for in the approved budgets, long-term strategy, organizational development plans and the appointment of senior executive officers. Management is authorized to act, without Board approval, on all ordinary course matters relating to the Company's business.

The mandate provides that the Board also expects management to provide the directors, on a timely basis, with information concerning the business and affairs of the Company, including financial and operating information and information concerning industry developments as they occur, all with a view to enabling the Board to discharge its stewardship obligations effectively. The Board expects management to efficiently implement its strategic plans for the Company, to keep the Board fully apprised of its progress in doing so and to be fully accountable to the Board in respect to all matters for which it has been assigned responsibility.

The Board has instructed management to maintain procedures to monitor and promptly address shareholder concerns and has directed and will continue to direct management to apprise the Board of any major concerns expressed by shareholders.

Each Committee of the Board is empowered to engage external advisors as it sees fit. Any individual director is entitled to engage an outside advisor at the expense of the Company provided such director has obtained the approval of the Nominating and Corporate Governance Committee to do so. In order to ensure that the principal business risks borne by the Company are identified and appropriately managed, the Board receives periodic reports from management of the Company's assessment and management of such risks. In conjunction with its review of operations, the Board considers risk issues when appropriate and approves corporate policies addressing the management of the risk of the Company's business.

The Board takes ultimate responsibility for the appointment and monitoring of the Company's senior management. The Board approves the appointment of senior management and reviews their performance on an ongoing basis.

The Company has a disclosure policy addressing, among other things, how the Company interacts with analysts and the public, and contains measures for the Company to avoid selective disclosure. The Company has a Disclosure Committee responsible for overseeing the Company's disclosure practices. This committee consists off the Chairman, President and Chief Executive Officer, Chief Financial Officer, Vice President and Corporate Secretary, Vice President of Investor Relations and External Affairs, Manager of Investor Relations, Vice President of Project Evaluation and Resource Development, and Resource Manager-Project Evaluation and Resource Development. The Disclosure Committee assesses materiality and determines when developments justify public disclosure. The committee reviews the disclosure policy annually and as otherwise needed to ensure compliance with regulatory requirements as well as review all documents which are reviewed by the Board and Audit Committee. The Board reviews and approves the Company's material disclosure documents, including its annual report, annual information form and management proxy circular. The Company's annual and quarterly financial statements, Management's Discussion and Analysis and other financial disclosure are reviewed by the Audit Committee and recommended to the Board prior to release.

Committees of the board

Audit Committee

The Board has established an Audit Committee, which operates under a charter approved by the Board. It is the Board's responsibility to ensure that the Company has an effective internal control framework. This includes internal controls to deal with both the effectiveness and efficiency of significant business processes, the safeguarding of assets, the maintenance of proper accounting records, and the reliability of financial information as well as non-financial considerations such as the benchmarking of operational key performance indicators. The Company's Audit Committee consists of Messrs. Deepwell, Lebel and Lancaster. Mr. Deepwell is the chairman of the Audit Committee.

The primary objective of the Audit Committee of the Company is to act as a liaison between the Board and the Company's independent auditors (the "Auditors") and to assist the Board in fulfilling its oversight responsibilities with respect to (a) the financial statements and other financial information provided by the Company to its shareholders, the public and others, (b) the Company's compliance with legal and regulatory requirements, (c) the qualification, independence and performance of the Auditors and (d) the Company's risk management and internal financial and accounting controls, and management information systems.

Although the committee has the powers and responsibilities set forth in its charter, the role of the committee is oversight. The members of the committee are not employees of the Company and may or may not be accountants or auditors by profession or experts in the fields of accounting or auditing and, in any event, do not serve in such capacity. Consequently, it is not the duty of the committee to conduct audits or to determine that the Company's financial statements and disclosures are complete and accurate and are in accordance with generally accepted accounting principles and applicable rules and regulations. These are the responsibilities of management and the Auditors.

All services to be performed by the Company's independent auditor must be approved in advance by the Audit Committee or a designated member of the Audit Committee ("Designated Member"). The Designated Member is a member of the Audit Committee who has been given the authority to grant pre-approvals of permitted audit and non-audit services. Pre-approvals by the Designated Member are ratified by the Audit Committee at the next meeting thereof.

The Audit Committee has considered whether the provision of services other than audit services is compatible with maintaining the auditors' independence and has adopted a policy governing the provision of these services. This policy requires the pre-approval by the Audit Committee or the Designated Member of all audit and non-audit services provided by the external auditor, other than any *de minimis* non-audit services allowed by applicable law or regulation. The decisions of the Designated Member to pre-approve permitted services need to be reported to the Audit Committee at its regularly scheduled meetings. Pre-approval from the Audit Committee or Designated Member can be sought for planned engagements based on budgeted or committed fees. No further approval is required to pay pre-approved fees. Additional pre-approval is required for any increase in scope or in final fees. Pursuant to these procedures, 100% of each of the services provided by the Company's external auditor relating to the fees reported as audit, audit-related, tax and other fees were pre-approved by the Audit Committee or the Designated Member.

The committee held four meetings during the Financial Year. In performing its duties in accordance with the Audit Committee Charter, the Audit Committee has:

- overseen the relationship with the Company's auditors;
- reviewed the interim and annual financial statements;
- reviewed and assessed the effectiveness of systems of risk management and internal controls; and
- reported to the Board on the proceedings and deliberations of the Committee.

Nominating and Corporate Governance Committee

The Board has established a Nominating and Corporate Governance Committee, which operates under a charter approved by the Board. The primary objective of the Nominating and Corporate Governance Committee is to assist the Board in fulfilling its oversight responsibilities by (a) identifying individuals qualified to become Board and committee of the Board members and recommending that the Board select director nominees for appointment or election to the Board; and (b) developing and recommending to the Board corporate governance guidelines for the Company and making recommendations to the Board with respect to corporate governance practices. The Nominating and Corporate Governance Committee monitors the disclosure of conflicts of interest to the Board and ensures that no director will vote or participate in a discussion on a matter in respect of which such director has a material interest. Committee Chairs perform the same function with respect to meetings of each Board committee. The members of the Nominating and Corporate Governance Committee are Messrs. Hanson, Deepwell, Lebel, Angus, Lancaster and Flood. Mr. Hanson is the chairman of the Nominating and Corporate Governance Committee.

Compensation and Benefits Committee

The Board has established a Compensation and Benefits Committee, which operates under a charter approved by the Board. The primary objective of the Compensation and Benefits Committee is to discharge the Board's responsibilities relating to compensation and benefits for the Directors and executive officers of the Company. This role includes reviewing and approving executive compensation including long-term incentive components and making applicable recommendations to the Board, administering the Employee Incentive Plan ("EIP"), determining the recipients of, and the nature and size of share compensation awards and bonuses granted from time to time, and reviewing reports as may be required under applicable laws and regulations. The members of the Compensation and Benefits Committee are Messrs. Lancaster, Angus, Deepwell and Lebel. Mr. Flood resigned from the committee on February 16, 2011. Mr. Lancaster is the chairman of the Compensation and Benefits Committee.

Health, Environment, Safety and Social Responsibility Committee

The Board has established a Health, Environment, Safety and Social Responsibility ("HESS") Committee. The primary objective of the HESS Committee is to review and oversee the Company's established HESS policies and procedures at the Company's project sites. The Committee also reviews any incidents that occur and provides guidance on how to prevent any recurrences. The members of the HESS Committee are Messrs. Hanson, Molyneux and Macken. Mr. Hanson is the chairman of the HESS Committee.

Mergers and Acquisitions Committee

The Board has established a Mergers and Acquisitions ("M&A") Committee. The primary objective of the M&A Committee is to review, assess and provide guidance on all potential acquisitions, divestitures and strategic investment transactions to which the Company may become a party. The members of the M&A Committee in 2011 were Messrs. Lebel, Angus and Flood. Mr. Lebel is the chairman of the M&A Committee. Mr. Lancaster joined the committee on March 14, 2012.

Ad hoc/special committees

In appropriate circumstances, the Board may establish a special committee to review a matter in which several directors or management may have a conflict of interest.

Meetings of the board and committees of the board

The Board holds regular quarterly meetings. Between quarterly meetings, the Board meets as required, generally by means of telephone conferencing facilities. As part of the quarterly meetings, the non-management directors also have the opportunity to meet separate from management. If required, between regularly scheduled Board meetings, a meeting of non-management Directors, chaired by the Lead Director, is held by teleconference to update the Directors on corporate developments since the last Board meeting. Management also communicates informally with members of the Board on a regular basis, and may solicit the advice of the Board members on matters falling within their special knowledge or experience.

During the Financial Year, five meetings of the Board of Directors, four meetings of the Audit Committee, four meetings of the Nominating and Corporate Governance Committee, four meetings of the Compensation and Benefits Committee, four meetings of the Health, Environment, Safety and Social Responsibility Committee and four meetings of the Mergers and Acquisitions Committee were held. Attendance by directors at the Board and Committee meetings is shown below:

Attendance record for the Board and Board Committee meetings during the Financial Year	Board meetings	Audit Committee meetings	Nominating and Corporate Governance Committee meetings	Compensation and Benefits Committee meetings	Health, Environment, Safety and Social Responsibility Committee meetings	Mergers and Acquisitions Committee meetings
	(Number of Attendances/Number of Meetings)					
Executive Directors						
Mr. Alexander Molyneux	5/5	N/A	N/A	N/A	4/4	4/4
Non-Executive Directors						
Mr. Peter Meredith *(Chairman)*	5/5	N/A	N/A	N/A	N/A	N/A
Mr. John Macken	4/5	N/A	N/A	N/A	4/4	N/A
Independent Non-Executive Directors						
Mr. Pierre Lebel *(Lead Director)*	5/5	4/4	4/4	4/4	N/A	4/4
Mr. André Deepwell	5/5	4/4	4/4	4/4	N/A	N/A
Mr. R. Stuart (Tookie) Angus	5/5	N/A	3/4	4/4	N/A	3/4
Mr. Robert Hanson	5/5	N/A	4/4	N/A	4/4	N/A
Mr. R. Edward Flood (1)	5/5	N/A	4/4	N/A	N/A	3/4
Mr. W. Gordon Lancaster (2)	5/5	4/4	4/4	4/4	N/A	N/A

(1) Mr. Flood resigned from the Compensation and Benefits Committee on February 16, 2011

(2) Mr. Lancaster joined the M&A Committee on March 14, 2012

Code of business conduct and ethics

The Company has adopted a Code of Business Conduct and Ethics and Corporate Securities Trading Policy with companion booklet and a Statement of Values and Responsibilities applicable to all employees, consultants, officers and directors regardless of their position in the organization, at all times and everywhere the Company does business. The Code of Business Conduct and Ethics provides that the Company's employees, consultants, officers and directors will uphold its commitment to a culture of honesty, integrity and accountability and the Company requires the highest standards of professional and ethical conduct from its employees, consultants, officers and directors. In 2010 the Company's management created a companion booklet to the Code of Business Conduct and Ethics to provide the Company's directors, employees and consultants with information pertaining to anti-bribery laws in Canada and the U.S. under the Corruption of Foreign Public Officials Act and the Foreign Corrupt Practices Act respectively.

Company supervisors, employees and consultants are required to confirm, on an annual basis, that they have received, reviewed and understand the contents and agree to abide by the Company's Code of Business Conduct and Ethics.

The Audit Committee monitors compliance with the Code of Business Conduct and Ethics. The Nominating and Corporate Governance Committee monitors the disclosure of conflicts of interest by directors with a view to ensuring that no director votes or participates in any board deliberations on a matter in respect of which such director has a material interest.

Appointment and re-election of directors

The Board determines, in light of the opportunities and risks facing the Company, what competencies, skills and personal qualities it should seek in new board members in order to add value to the Company. Based on this framework, the Nominating and Corporate Governance Committee developed a skills matrix outlining the Company's desired complement of directors' competencies, skills and characteristics. The specific make-up of the matrix includes such items and experiences as international experience, leading growth-orientated companies, mining exploration, diversity, financial literacy, legal knowledge, corporate governance, etc. The committee annually assesses the current competencies and characteristics represented on the Board and utilize the matrix to determine the Board's strengths and identify any gaps that need to be filled. This analysis assists the committee in discharging its responsibility for approaching and proposing to the full Board new nominees to the Board, and for assessing directors on an ongoing basis.

Unless a director dies, resigns or is removed from office in accordance with the BCBCA, the term of office of each of the incumbent directors ends at the conclusion of the next annual meeting of the shareholders following his or her most recent election or appointment.

At every annual general meeting the shareholders entitled to vote at the annual general meeting for the election of directors are entitled to elect a board consisting of the number of directors for the time being set under the articles of continuation for the Company and all the directors cease to hold office immediately before such election but are eligible for re-election. If the Company fails to hold an annual general meeting on or before the date by which the annual general meeting is required to be held under the BCBCA or the shareholders fail, at the annual general meeting, to elect or appoint any directors then, each director then in office continues to hold office until the earlier of:

- the date on which his or her successor is elected or appointed; and
- the date on which he or she otherwise ceases to hold office under the BCBCA or the articles of continuation.

Securities transactions by directors

The Company has adopted policies in its Corporate Disclosure, Confidentiality and Securities Trading policy that have terms that are no less exacting than those set out in the Model Code in Appendix 10 of the rules governing the listing of securities on the Hong Kong Stock Exchange, having made specific enquiry of all directors, whether the directors of the listed issuer have complied with, or whether there has been any non-compliance with, the required standard set out in the Model Code and its code of conduct regarding directors' securities transactions.

Furthermore, if a director (a) enters into a transaction involving a security of the Company or, for any other reason, the direct or indirect beneficial ownership of, or control or direction over, securities of the Company changes from that shown or required to be shown in the latest insider report filed by the director, or (b) the director enters into a transaction involving a related financial instrument, the director must, within the prescribed period, file an insider report in the required form on the SEDI website at www.sedi.ca and a Form 3A is filed with the Stock Exchange of Hong Kong Ltd.

A "related financial instrument" is defined as:
(a) an instrument, agreement, security or exchange contract the value, market price or payment obligations of which are derived from, referenced to or based on the value, market price or payment obligations of a security, or (b) any other instrument, agreement or understanding that affects, directly or indirectly, a person's economic interest in respect of a security or an exchange contract.

Remuneration of directors

The Compensation and Benefits Committee periodically reviews and makes recommendations to the Board regarding the adequacy and form of the compensation for non-management directors to ensure that such compensation realistically reflects the responsibilities and risks involved in being an effective director, without compromising a director's independence. Directors who are executives of the Company receive no additional remuneration for their services as directors.

All independent non-executive directors receive Cdn$25,000 per annum for acting as such. Mr. Lebel receives an additional Cdn$60,000 per annum for acting as the Lead Director of the board. The chair of the Audit Committee receives an additional Cdn$40,000 per annum, for acting in such capacity. The respective chairs of the Compensation and Benefits Committee and the Nominating and Corporate Governance Committee each receive an additional payment of Cdn$25,000 per annum for acting as such. Additionally, independent directors receive Cdn$1,500 per in-person Board or Committee meeting attended and Cdn$600 per Board or Committee conference call in which they participate.

In addition to their cash compensation, non-executive directors also receive a grant of 35,000 stock options per annum, such options having a five-year term and fully vesting on the first anniversary of the date of the grant. In 2011, Mr. Lebel received an additional 5,000 stock options for acting as Lead Director.

Details regarding the remuneration of directors of the Company are set out in Note A2 of the Financial Statements.

Internal controls

The Board is responsible for overseeing the internal controls of the Company. Internal controls are used by the Board to: facilitate the effectiveness and efficiency of operations, safeguard the investment of shareholders and assets of the Company and to ensure compliance with relevant statutory and regulatory requirements. The Company's internal control policies are designed to provide reasonable, but not absolute, assurance against material misstatements and help the Board identify and mitigate, but not eliminate, risk exposure.

The Board conducts annual reviews of the internal controls of the Company to ensure that internal control policies and procedures are adequate. The Audit Committee reviewed the effectiveness of the Company's internal control policies as at December 31, 2011, and is of the view that the internal control system in place is effective in safeguarding the investment of shareholders and assets of the Company.

Auditors

Deloitte & Touche LLP was the auditor of SouthGobi Resources Ltd. during the year ended December 31, 2011 and is independent within the meaning of the Rules of Professional Conduct of the Institute of Chartered Accountants of British Columbia. The financial reporting responsibilities and audit report of the independent auditors are set out on page 93.

A resolution will be submitted at the annual general meeting to appoint PricewaterhouseCoopers as auditors of the Company for the year ending December 31, 2012.

Fees paid/payable to the external auditors, Deloitte and Touche LLP, in respect of audit and non-audit services provided during the year ended December 31, 2011 were as follows:

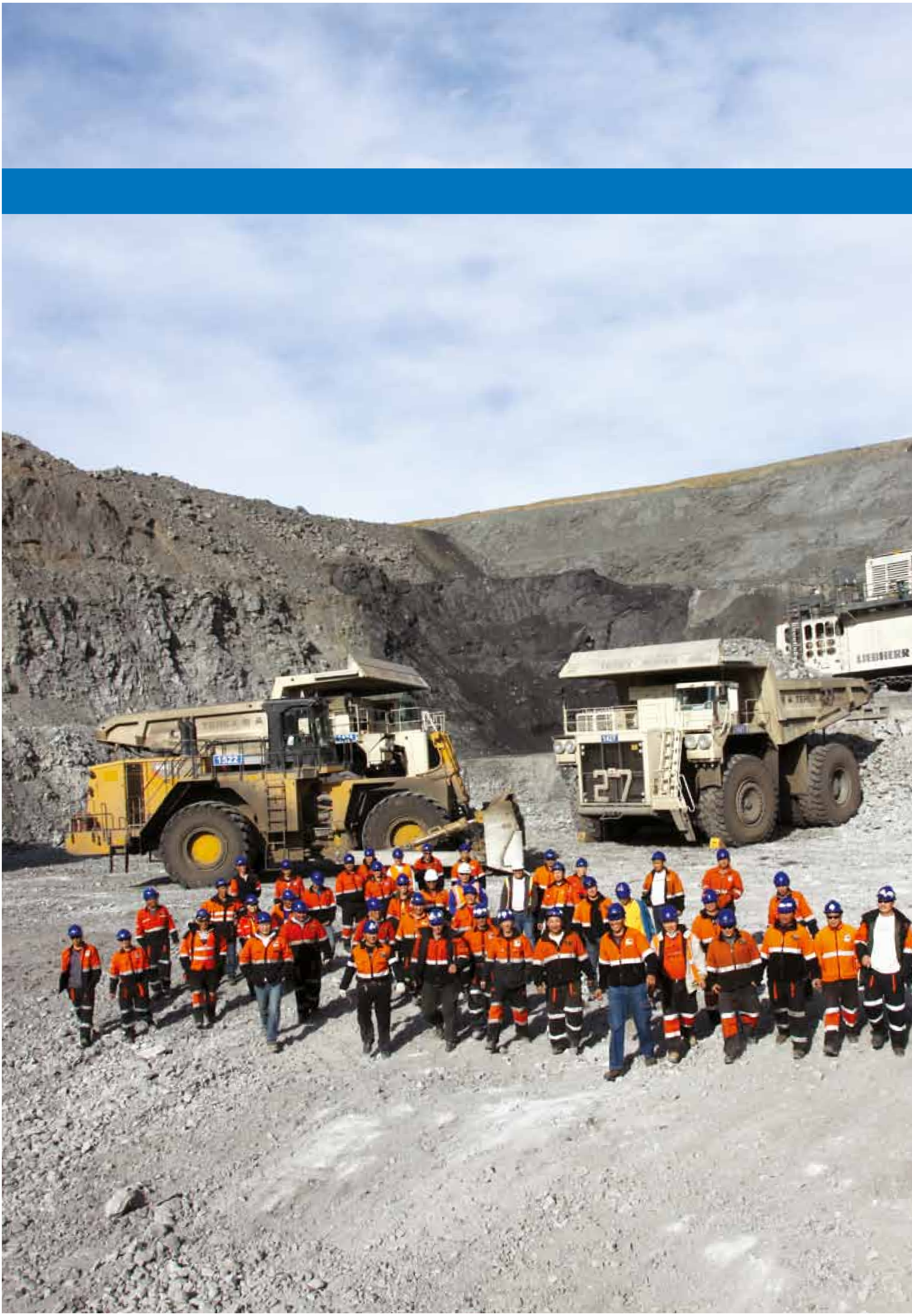
Nature of services rendered	Fees paid/payable (US$ 000's)
Audit fees [(a)]	275
Non-audit fees [(b)]	217
Total	**492**

(a) Fees for audit services billed consisted of:
- audit of the Company's annual financial statements
- reviews of the Company's interim financial statements
- comfort letters, consents and other services related to the Canadian securities regulatory and authorities' matters

(b) Fees for non-audit services billed consisted of:
- fees for tax services consisting of income tax compliance and tax planning and advice relating to transactions and proposed transactions of the Company and its subsidiaries

Responsibilities in respect of the financial statements

The directors acknowledge their responsibility in overseeing the preparation of financial statements that give a true and fair view of the financial affairs of the Company. With the assistance of the management of the Company, the directors ensure that the financial statements of the Company are being prepared and published in a timely manner and in accordance with the applicable accounting standards and statutory requirements.



Management's discussion and analysis of financial condition and results of operations

December 31, 2011

(Unaudited)

(Expressed in U.S. dollars)

Forward-looking statements

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

Table of contents

1. Overview

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

SouthGobi's common shares trade on the Toronto Stock Exchange ("TSX") under the symbol SGQ and on the Hong Kong Stock Exchange ("HKEX") under the stock code symbol 1878.

The Company owns the following significant coal projects in Mongolia: the Ovoot Tolgoi open pit producing coal mine ("Ovoot Tolgoi Mine") and three development projects, the Soumber Deposit, the Zag Suuj Deposit and the Ovoot Tolgoi Underground Deposit. These projects are located in the Umnugobi Aimag (South Gobi Province) of Mongolia, within 150 kilometers ("km") of each other and in close proximity to the Mongolia-China border.

The Ovoot Tolgoi Mine together with the Ovoot Tolgoi Underground Deposit forms the Ovoot Tolgoi Complex. The Ovoot Tolgoi Complex is separated into two distinct areas, the Sunrise and Sunset Pits (formerly the South-East and West Fields, respectively).

The Ovoot Tolgoi Mine, strategically located approximately 40km from the Shivee Khuren-Ceke crossing at the Mongolia-China border ("Shivee Khuren Border Crossing"), is the Company's flagship producing asset. SouthGobi commenced mining at Ovoot Tolgoi's Sunset Pit in April 2008 and commenced coal sales in September 2008. In August 2011, the Company commenced mining and sales at Ovoot Tolgoi's Sunrise Pit. Current products from the Ovoot Tolgoi Mine include coals with coking (or metallurgical) applications, primarily a raw semi-soft coking coal together with raw medium and higher-ash coals, which can be washed and blended into semi-soft coking coal. The Ovoot Tolgoi Mine is covered by a single 9,308 hectare ("ha") mining license and a corresponding permit to mine.

The Soumber Deposit, comprising the Central Soumber, East Soumber, Biluut, South Biluut and Jargalant Fields, is located approximately 20km to the east of the Ovoot Tolgoi Mine, which will allow any future mining operation at the Soumber Deposit to share existing infrastructure. Exploration results show potential for thick seams of coking coal and a resource has been established confirming the deposit. On June 3, 2011, the Company announced it had successfully registered the resource associated with the Soumber Deposit (at that time comprising the Central Soumber, East Soumber and Biluut Fields) with the Mineral Resource Authority of Mongolia ("MRAM"). Further, on July 6, 2011, the Company announced that MRAM had issued the Company a mining license pertaining to the Soumber Deposit. The new 10,993ha mining license was granted for an initial term of 30 years with an option for two 20 year extensions.

1. Overview continued

A successful exploration program in the vicinity of the Soumber Deposit during 2011 has resulted in additional coal resources being identified. Resources associated with the South Biluut and Jargalant Fields have been through the resource registration process and the exploration licenses pertaining to resources outside the mining license are subject to Pre-Mining Agreement ("PMA") applications. Subsequent to the receipt of the PMA, the Company intends to proceed through to the mining license application process.

The Zag Suuj Deposit is located approximately 150km east of the Ovoot Tolgoi Mine and approximately 80km north of the Mongolia-China border. A maiden National Instrument 43-101 ("NI 43-101") compliant resource has been established for the Zag Suuj Deposit. Exploration results indicate potential for thick coal seams and it is anticipated that the coals from the Zag Suuj Deposit can be washed to produce a coking coal or coking coal blend product. Exploration activities will continue on the deposit in 2012. The Zag Suuj Deposit resource has been through the resource registration process and the exploration licenses pertaining to it are subject to PMA applications.

The Company has conducted substantial exploration activities at the Ovoot Tolgoi Underground Deposit and has delineated mineral resources at this project. SouthGobi is currently studying options to mine the resource in the future. The Ovoot Tolgoi Underground Deposit is covered by the existing Ovoot Tolgoi mining license.

As at December 31, 2011, SouthGobi owned 19.9% of Aspire Mining Limited ("Aspire"), a company listed on the Australian Stock Exchange under the symbol AKM. Aspire's primary focus is its mineral exploration licenses in Mongolia, particularly those pertaining to the Ovoot Coking Coal Project.

As at March 19, 2012, Ivanhoe directly owned 104.8 million common shares representing approximately 58% of the issued and outstanding common shares of SouthGobi.

1.1 Corporate highlights

SouthGobi achieved record annual sales of 4.02 million tonnes in 2011, an increase of 58% from 2010 due to the continued expansion of the Company's customer base. The Company recognized record annual revenue of $179.0 million in 2011, an increase of 124% from 2010 due to increased sales volumes and increased selling prices for individual coal types.

SouthGobi continued to ramp-up operations in 2011. Coal production increased to 4.57 million tonnes in 2011 from 2.79 million tonnes in 2010, an increase of 64%, demonstrating the successful expansion of operations at the Company's Ovoot Tolgoi Mine.

The average realized selling price increased to $54.03 per tonne in 2011, an increase of 56% from 2010. This is a result of SouthGobi's successful marketing initiatives over the year and demonstrates the ongoing erosion of the pricing gap between domestic Chinese price indices and prices for coking coal products traded at the Shivee Khuren Border Crossing.

1. Overview continued

1.1 Corporate highlights continued

Gross profit increased to $51.7 million in 2011 from $9.9 million in 2010, an increase of 424% and the result of increased sales volumes and expanding product margins.

On March 19, 2012, SouthGobi announced updated NI 43-101 compliant estimates of resources and reserves, which increased overall measured plus indicated resources by 35% (from 363.6 million tonnes to 492.6 million tonnes total) and inferred resources by 42% (from 171.9 million tonnes to 244.0 million tonnes total) and increased proven and probable reserves for the Ovoot Tolgoi Mine by 65% (from 106.8 million tonnes to 175.7 million tonnes total).

On March 5, 2012, SouthGobi announced an agreement to sell the Tsagaan Tolgoi Deposit to Modun Resources Limited ("Modun"), a company listed on the Australian Stock Exchange under the symbol MOU. Under the transaction, SouthGobi expects to receive $30.0 million of total consideration, comprising $7.5 million up-front in cash, $12.5 million up-front in Modun shares and deferred consideration of an additional $10.0 million also payable in Modun shares.

On February 13, 2012, the Company announced the successful commissioning of the dry coal-handling facility ("DCHF") at the Ovoot Tolgoi Mine. The DCHF has capacity to process nine million tonnes of run-of-mine ("ROM") coal per year. The DCHF includes a 300-tonne-capacity dump hopper, which receives ROM coal from the Ovoot Tolgoi Mine and feeds a coal rotary breaker that sizes coal to a maximum of 50 millimeters ("mm") and rejects oversize ash. The rotary breaker is anticipated to reduce screening costs and improve yield recoveries.

On July 5, 2011, the Company entered into an agreement with Ejinaqi Jinda Coal Industry Co. Ltd ("Ejin Jinda"), a subsidiary of China Mongolia Coal Co. Ltd ("CMC"), to toll wash medium and higher-ash coals from the Ovoot Tolgoi Mine, with only basic processing through the DCHF, at Ceke. Washed coal will generally meet semi-soft coking coal specifications.

On August 2, 2011, SouthGobi Sands LLC, a wholly owned Mongolian subsidiary of SouthGobi, was awarded the tender to construct a paved highway from the Ovoot Tolgoi Complex to the Shivee Khuren Border Crossing with consortium partner NTB LLC. When completed, the paved highway will reduce trucking costs and increase export capacity to 20 million tonnes per annum.

On July 6, 2011, SouthGobi announced that MRAM had issued a mining license pertaining to the Soumber Deposit. The new 10,993ha mining license is granted for an initial term of 30 years with an option for two 20 year extensions.

2. Selected annual information

($ in thousands, except per share information)

	Year ended December 31,		
	2011	2010	2009
Revenue	**$179,049**	$79,777	$36,038
Gross profit	**51,706**	9,873	6,613
Net income/(loss) from continuing operations	**57,745**	(116,195)	(79,717)
Loss from discontinued operations	**–**	–	(31,088)
Net income/(loss)	**57,745**	(116,195)	(110,805)
Net income/(loss) per share – basic			
Continuing operations	**0.32**	(0.66)	(0.60)
Discountinued operations	**–**	–	(0.23)
Total	**0.32**	(0.66)	(0.83)
Net income/(loss) per share – diluted			
Continuing operations	**(0.19)**	(0.66)	(0.60)
Discountinued operations	**–**	–	(0.23)
Total	**(0.19)**	(0.66)	(0.83)
Adjusted net loss (i)	**(10,943)**	(49,208)	(22,172)
Cash and cash equivalents	**123,567**	492,038	357,342
Short term investments	**–**	17,529	14,999
Long term investments			
Money market investments	**44,967**	45,173	47,194
Other long term investments (ii)	**54,271**	62,243	9,876
Total assets	**920,323**	961,866	560,684
Total long term liabilities	**145,607**	252,527	543,086

(i) A non-IFRS financial measure, see Section 5

(ii) As at December 31, 2011, other long term investments include a $7.4 million investment in Kangaroo Resources Ltd. ("Kangaroo") and a $46.8 million investment in Aspire

2. Selected annual information continued

In 2011, SouthGobi recorded revenue of $179.0 million compared to $79.8 million in 2010 and $36.0 million in 2009. The significant increase in revenue can be attributed to increased sales volumes and increased selling prices for individual coal types.

Gross profit in 2011 increased to $51.7 million from $9.9 million in 2010 and $6.6 million in 2009 due to increased sales volumes and expanding product margins.

The Company recorded net income from continuing operations of $57.7 million in 2011 compared to a net loss from continuing operations of $116.2 million in 2010 and $79.7 million in 2009. In 2010, $250.0 million of the China Investment Corporation ("CIC") convertible debenture was converted to common shares resulting in a $151.4 million non-cash loss on partial conversion of the debt.

Net income in 2011 includes gross profit of $51.7 million (2010: $9.9 million), offset by other operating expenses of $29.2 million (2010: $12.6 million), administration expenses of $28.7 million (2010: $25.4 million) and evaluation and exploration expenses of $31.8 million (2010: $18.8 million). Net income also includes financing costs related to the CIC convertible debenture. In 2011, the fair value change of the embedded derivatives in the CIC convertible debenture resulted in a non-cash gain of $106.5 million (2010: $100.6 million gain).

The net loss in 2009 included $31.1 million in discontinued operations for the Indonesian Coal Division.

Adjusted net loss (a non-IFRS financial measure, see Section 5) was $10.9 million in 2011 compared to $49.2 million in 2010 and $22.2 million in 2009. Adjusted net loss decreased compared to 2010 primarily due to increased gross profit as a result of increased sales volumes and expanding product margins and lower interest expense, partially offset by higher exploration expenses.

The Company's total assets at December 31, 2011 were $920.3 million compared to $961.9 million at December 31, 2010 and $560.7 million at December 31, 2009. At December 31, 2011, the Company had $123.6 million in cash and cash equivalents and $99.2 million in long term investments compared to $492.0 million in cash and cash equivalents, $17.5 million in short term investments and $107.4 million in long term investments at December 31, 2010. Long term investments include $45.0 million of money market investments (2010: $45.2 million), a $7.4 million investment in Kangaroo (2010: $10.2 million) and a $46.8 million investment in Aspire (2010: $52.0 million). The decrease in cash and cash equivalents from 2010 primarily resulted from the expansion of operations at the Ovoot Tolgoi Mine.

The Company's long term liabilities at December 31, 2011 were $145.6 million compared to $252.5 million at the end of 2010 and $543.1 million at the end of 2009. The 2011 decrease in the long term liabilities is primarily due to the $106.5 million fair value change of the embedded derivatives in the CIC convertible debenture. The 2010 decrease in long term liabilities is primarily due to the partial conversion of $250.0 million of the CIC convertible debenture into common shares of the Company.

3. Results of operations

Disclosure of a scientific or technical nature in this Management's Discussion and Analysis ("MD&A") with respect to the Company's Mongolian Coal Division was prepared by, or under the supervision of Dave Bartel, P.Eng., the Company's Senior Engineer. Mr. Bartel is a "qualified person" for the purposes of NI 43-101 of the Canadian Securities Administrators.

3.1 Mongolian coal division

As at March 1, 2012, the Company held three mining licenses and eight exploration licenses (four of which have PMA applications lodged), which in total cover an area of approximately 418,000ha.

Pursuant to the Mining Prohibition in Specified Areas Law, the Government of Mongolia was to define the boundaries of the areas in which exploration and mining would be prohibited by October 16, 2009. However, the Government of Mongolia has not yet approved and published this information.

A draft list of licenses has been prepared that overlap with the prohibited areas described in the new law based on information submitted by water authority agencies, forest authority agencies and local authorities for submission to the Government of Mongolia. In February 2011, the potential forest and water areas were updated. The Government of Mongolia must give its final approval before the final list can be published; licenses may be added or subtracted to the list at any time prior to approval and publication of the final list.

The Company's Tsagaan Tolgoi mining license and exploration licenses pertaining to the Zag Suuj Deposit and the South Biluut and Jargalant Fields within the Soumber Deposit, as well as two other exploration licenses, may be included on the draft list of licenses published by the Government of Mongolia, potentially affecting the status of those licenses under the Mining Prohibition in Specified Areas Law.

Activities currently being carried out on these exploration properties include drilling, trenching and geological reconnaissance. The Company has no immovable assets located in any of the potentially affected areas and the loss of any or all of the potentially affected properties would not materially and adversely affect the existing operations.

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

Operating mines

Ovoot Tolgoi Mine

The Ovoot Tolgoi Mine is located in the southwest corner of the Umnugobi Aimag (South Gobi Province) of Mongolia. The deposit is within the administrative unit of Gurvantes Soum, 270km southwest of the provincial capital of Dalanzadgad and 700km southwest of the nation's capital of Ulaanbaatar. To date, mining operations at the Ovoot Tolgoi Mine have been carried out in two distinct areas, the Sunset Pit to the west and the Sunrise Pit to the east.

Current products from the Ovoot Tolgoi Mine include coals with coking (or metallurgical) applications, primarily a raw semi-soft coking coal together with raw medium and higher-ash coals, which can be washed and blended into semi-soft coking coal.

3. Results of operations continued

3.1 Mongolian coal division continued

Operating mines continued

Reserves and resources

On March 19, 2012, the Company announced an updated NI 43-101 compliant independent resource estimate prepared by Minarco-MineConsult ("MMC"). MMC estimated that the Ovoot Tolgoi Mine contains 175.7 million tonnes of proven and probable surface coal reserves, 133.3 million tonnes of measured coal resources, 59.9 million tonnes of indicated coal resources and 24.0 million tonnes of inferred coal resources as at October 31, 2011. All of these resources are located above 300m and are amenable to surface mining. The mineral resources are inclusive of mineral reserves. Details of the assumptions and parameters used to calculate the reserves, resources and coal quality estimates and information on data verification are set out in the Annual Information Form dated March 19, 2012, and available at www.sedar.com.

The coal rank at the Ovoot Tolgoi Mine is high volatile B to A bituminous based on the ASTM D388 standard. High volatile B produces between 7,212 to 7,785 kcal/kg and high volatile A produces greater than 7,785 kcal/kg heat output.

Select financial and operational data

	Year ended December 31,	
	2011	2010
Volumes, Prices and Costs		
Raw coal production *(millions of tonnes)*	**4.57**	2.79
Coal sales *(millions of tonnes)*	**4.02**	2.54
Average realized sales price *(per tonne)*	**$54.03**	$34.61
Direct cash costs of product sold *(per tonne)*	**$23.15**	$19.66
Total cash costs of product sold *(per tonne)*	**$24.01**	$20.70
Operating Statistics		
Production waste material moved *(millions of bank cubic meters)*	**16.61**	9.69
Strip ratio *(bank cubic meters of waste rock per tonne of coal produced)*	**3.63**	3.47
Pre-production waste material moved *(millions of bank cubic metres)*	**1.68**	1.18
Operating Results ($ in thousands)		
Revenue	**$179,049**	$79,777
Cost of sales	**(127,343)**	(69,904)
Gross profit	**$51,706**	$9,873

In 2011, the Company produced 4.57 million tonnes of raw coal with a strip ratio of 3.63 compared to production of 2.79 million tonnes of raw coal in 2010 with a strip ratio of 3.47. Mining capacity increased in 2011 due to the commissioning of additional mining equipment. Mining activities also commenced in the Sunrise Pit during the third quarter of 2011. In 2010, production was negatively impacted by the Sunset Pit realignment in the first half of 2010. Realigning the Sunset Pit impacted operations because the process required substantial above-trend waste removal, which resulted in lower production volumes.

3. Results of operations continued

3.1 Mongolian coal division continued

Operating mines continued

Select financial and operational data continued

In 2011, the Company sold 4.02 million tonnes of coal at an average realized selling price of $54.03 per tonne. This compares to 2.54 million tonnes of coal sold in 2010 at an average realized selling price of $34.61 per tonne. The Company continues to focus its marketing efforts on the expansion of its customer base.

Revenue increased from $79.8 million in 2010 to record annual revenue of $179.0 million in 2011. The significant increase in revenue can be attributed to increased sales volumes and increased selling prices for individual coal types (52% increase for raw semi-soft coking coal and 47% increase for raw higher-ash coal).

Revenues are presented net of royalties and selling fees. The Company is subject to a 5% royalty on all coal sold based on a set reference price per tonne published monthly by the Government of Mongolia. Effective January 1, 2011, the Company is also subject to a sliding scale additional royalty of up to 5% based on the set reference price of coal. Based on the 2011 reference prices, the Company was subject to an average 8% royalty based on a weighted average reference price of $98.97 per tonne. The Company's effective royalty rate for 2011, based on the Company's average realized selling price of $54.03 per tonne, was 15%.

Together with other Mongolian mining companies affected by the escalation of effective royalty rates, a dialog was opened on this topic with the appropriate Government of Mongolia authorities with a view to moving to a more equitable process for setting reference prices. There has been a successful outcome in that commencing February 2012 royalty reference prices are now based off prices for coal products sold at the two main coal export border locations in Mongolia, namely Shivee Khuren-Ceke and Gashuun Sukhait-Ganqimaodao. The dialog is continuing, with the aim of having prices based off actual contract prices for sales at these locations, excluding export fees and Chinese VAT (i.e. revenue received for coal delivered to the Mongolia-China border prior to export).

Cost of sales was $127.3 million in 2011 compared to $69.9 million in 2010. Cost of sales comprise the direct cash costs of product sold, mine administration cash costs of product sold, equipment depreciation, depletion of mineral properties and share-based compensation. Cost of sales increased in 2011 compared to 2010 due to higher sales volumes and higher unit costs.

Direct cash costs of product sold (a non-IFRS financial measure, see Section 5) were $23.15 per tonne in 2011 compared to $19.66 per tonne in 2010. Direct cash costs have increased as a result of increased screening activities of the Company's raw higher-ash coal, higher fuel prices and general economic factors including the strengthening of the Mongolian Tugrik and the rate of inflation in Mongolia.

3. Results of operations continued

3.1 Mongolian coal division continued

Operating mines continued

Select financial and operational data continued

Prices of diesel fuel (approximately 25% of the Company's direct cash costs), were 55% higher per tonne of product sold for the year ended December 31, 2011 compared to the year ended December 31, 2010. Significant fuel shortages in Mongolia during the second quarter of 2011 forced the Company to pay a higher price to secure diesel fuel supplies. Government of Mongolia sources have advised SouthGobi that there is now an agreement to guarantee minimum monthly fuel supplies from each of Russia and China. Furthermore, during 2011 the Company completed construction of a new fuel storage facility at the Ovoot Tolgoi Mine to increase onsite fuel storage capacity to 1.3 million liters.

Mine administration cash costs of product sold per tonne (a non-IFRS financial measure, see Section 5) decreased to $0.86 per tonne in 2011 compared to $1.04 per tonne in 2010 due to the increased sales volumes in 2011.

Processing infrastructure

On February 13, 2012, the Company announced the successful commissioning of the DCHF at the Ovoot Tolgoi Mine. The DCHF has capacity to process nine million tonnes of ROM coal per year. The DCHF includes a 300-tonne-capacity dump hopper, which receives ROM coal from the Ovoot Tolgoi Mine and feeds a coal rotary breaker that sizes coal to a maximum of 50mm and rejects oversize ash. Prior to the commissioning of the rotary breaker, temporary screening operations were used at the Ovoot Tolgoi Mine to process higher-ash coals. Screening performed a similar function to the rotary breaker, namely rejecting oversize ash and sizing the coal to a maximum of 50mm; however, the rotary breaker is anticipated to reduce screening costs and improve yield recoveries.

During the course of 2012, the DCHF will be upgraded to include dry air separation modules and covered load out conveyors with fan stackers to take processed coals to stockpiles and enable more efficient blending.

To further enhance product value, the Company entered into an agreement with Ejin Jinda, a subsidiary of CMC, to wet wash coal from the Ovoot Tolgoi Mine on a tolling arrangement. The agreement has a duration of 5 years from commencement and provides for an annual wet washing capacity of approximately 3.5 million tonnes of input coal (i.e. sufficient capacity to wet wash medium and higher-ash coals after DCHF processing).

Ejin Jinda's wet washing facility is located approximately 10km inside China from the Shivee Khuren Border Crossing (i.e. approximately 50km from the Ovoot Tolgoi Mine). Medium and higher-ash coals with only basic processing through Ovoot Tolgoi's on-site DCHF will be transported from the Ovoot Tolgoi Mine to the facility under a separate transport agreement. Based on preliminary studies, the Company expects these coals can then be washed to produce coals with ash in the range of 8% to 11% at a yield of 85% to 90%. Ejin Jinda will charge the Company a single toll washing fee which will cover their expenses, capital recovery and profit. Washed coal will generally meet semi-soft coking coal specifications.

Construction of Ejin Jinda's wet washing facility is now complete and it has been connected to utility supply. The equipment is currently undergoing testing, including batch processing trials. Commissioning is expected to be completed early in the second quarter of 2012.

3. Results of operations continued

3.1 Mongolian coal division continued

Operating mines continued

Transportation infrastructure

Since the commencement of mining activities at the Ovoot Tolgoi Mine in 2008, SouthGobi has coordinated efforts with the Government of Mongolia and various agencies to improve border crossing capacity for coal trucks. In July 2009, Chinese and Mongolian authorities agreed to create designated coal transportation corridors at the Shivee Khuren Border Crossing. Four designated coal truck entry points were constructed on the Chinese side of the Shivee Khuren Border Crossing together with an additional four separate points for empty trucks to exit China for Mongolia. In 2011, SouthGobi, together with Mongolyn Alt Corporation ("MAK"), completed the road and construction works required on the Mongolian side of the border to match the Chinese infrastructure. The Company believes that with a total of eight truck crossing lanes the Shivee Khuren Border Crossing capacity will be increased to approximately 20 million tonnes or more. Commissioning of the new border crossing is expected in mid-2012.

On August 2, 2011, the State Property Committee of Mongolia awarded the tender to construct a paved highway from the Ovoot Tolgoi Complex to the Shivee Khuren Border Crossing to consortium partners NTB LLC and the Company's Mongolian operating subsidiary, SouthGobi Sands LLC (together referred to as "RDCC"). On October 26, 2011, RDCC signed the concession agreement with the State Property Committee of Mongolia. RDCC now has the right to conclude a 15 year build, operate and transfer agreement under the Mongolian Law on Concessions. RDCC has completed the design of the road and plan to commence construction in the first half of 2012. The paved highway will have an intended carrying capacity upon completion in excess of 20 million tonnes of coal per year.

A north-south railway line currently connects Ceke with Jiayuguan City in Gansu Province and with the interior of China. Another east-west railway line connects Ceke to Linhe, an industrial city in eastern Inner Mongolia. This line has a stated initial transportation capacity of approximately 15 million tonnes per year, with a planned increase to 25 million tonnes per year.

Mining equipment

SouthGobi continues to ramp-up production at the Ovoot Tolgoi Mine. The key elements of the currently commissioned mining fleets include: One Liebherr 996 ($34m^3$) hydraulic excavator, two Liebherr R9250 ($15m^3$) hydraulic excavators, eighteen Terex MT4400 (218 tonne capacity) haul trucks and seven Terex TR100 (91 tonne capacity) haul trucks, together with various pieces of ancillary equipment.

The Company commissioned nine Terex MT4400 (218 tonne capacity) haul trucks in the fourth quarter of 2011. Four Terex MT4400 (218 tonne capacity) haul trucks were commissioned to complement the Company's second Liebherr 996 hydraulic excavator ($34m^3$), which is expected to be commissioned in the first half of 2012. Three Terex MT4400 (218 tonne capacity) haul trucks were commissioned to maintain capacity as cycle times will increase due to the commissioning of the DCHF. Two Terex MT4400 (218 tonne capacity) haul trucks have also been commissioned to maintain capacity as the depth of the Sunset Pit increases, increasing cycle times.

3. Results of operations continued

3.1 Mongolian coal division continued

Operating mines continued

Mining equipment continued

On September 27, 2011, a fire occurred on the Company's Liebherr 996 hydraulic shovel that was commissioned at the Ovoot Tolgoi Mine in December 2009 (previously included in the mining fleet). Safety protocols were followed and there were no injuries. Following subsequent inspection and third-party reports, the Company decommissioned the machine and currently believes it is unlikely it will be repairable. Site inspections have been completed by the insurance underwriter and the Company has been advised that the damage will be covered by its insurance policy. As a result, the Company has derecognized the full carrying amount of the machine and recognized a receivable in the amount equal to the amount of the estimated net insurance proceeds.

To compensate for the loss of the Liebherr 996 hydraulic shovel, the Company has contracted to purchase an additional Liebherr R9250 (15m^3) hydraulic excavator, which will be commissioned in the first half of 2012.

The Company also plans to purchase additional Terex MT4400 (218 tonne capacity) haul trucks to replace its existing Terex TR100 (91 tonne capacity) haul trucks by the end of 2012, increasing the overall efficiency of the mining fleet.

Through the purchase of the additional mining equipment, SouthGobi has secured additional mining capacity to continue the ramp-up of its operations towards achieving steady-state production in 2015.

Workforce

SouthGobi Sands LLC employed 689 employees as at December 31, 2011. Of the 689 employees, 68, including expatriates, are employed in the Ulaanbaatar office, 5 in outlying smaller offices and 616 employees at the mine site. Of the total 689 employees based in Mongolia, 667 (97%) are Mongolian nationals and of those, 361 (52%) are residents of the local Gurvantes, Dalanzadgad, Sevrei and Noyon Soums.

Development projects

Soumber Deposit

The Soumber Deposit, comprising the Central Soumber, East Soumber, Biluut, South Biluut and Jargalant Fields, is located approximately 20km east of the Ovoot Tolgoi Mine. It lies within the administrative units of Gurvantes and Noyon Soums in the Umnugobi Aimag (South Gobi Province), approximately 50km northeast of the Shivee Khuren Border Crossing. The proximity of the Soumber Deposit to the Ovoot Tolgoi Mine will allow any future mining operation at the Soumber Deposit to share existing infrastructure with the Ovoot Tolgoi Mine.

The 2011 exploration and drilling program at the Soumber Deposit (at that time comprising the Central Soumber, East Soumber and Biluut Fields) commenced in the second quarter of 2011, with the aim of expanding and better defining the resource. Approximately 83,980m of core and reverse circulation holes were drilled in 2011. A successful exploration program in 2011 has resulted in additional coal resources being identified. As a result, the Soumber Deposit now includes the Central Soumber, East Soumber, Biluut, South Biluut and Jargalant Fields.

3. Results of operations continued

3.1 Mongolian coal division continued

Development projects continued

Soumber Deposit continued

The Central and East Soumber Fields include six major seam groups. Approximately 40% of the resources are contained in one seam, averaging 5.9m in thickness. All seam groups consist of a number of coal plies of highly variable thickness, separated by stone partings. Interburden between the seam groups is mainly sandstone and conglomerate, whilst partings within the seam groups tend to be dominated by mudstone and carbonaceous mudstone.

Three major seams have been identified at the Biluut, South Biluut and Jargalant Fields. Correlation of these seams with the Central and East Soumber Fields has not been undertaken. Approximately 60% of the resources are contained in one seam, averaging 5.5m in thickness.

On March 19, 2012, the Company announced an updated NI 43-101 compliant independent resource estimate prepared by MMC. MMC estimated that the Soumber Deposit contains measured coal resources of 57.9 million tonnes, indicated coal resources of 79.3 million tonnes and inferred coal resources of 83.0 million tonnes as at January 25, 2012. Approximately 80% of the Soumber resource is located above 300m and is amenable to surface mining. Details of the assumptions and parameters used to calculate the resources and coal quality estimates and information on data verification are set out in the Annual Information Form dated March 19, 2012, and available at www.sedar.com.

The coal rank at the Soumber Deposit is low to medium volatile bituminous based on the ASTM D388 standard producing between 5,000 to 7,800 kcal/kg of heat output. Laboratory data demonstrated that some of the coal benches exhibit potential coking coal characteristics.

On June 3, 2011, the Company announced it had successfully registered the resource associated with the Soumber Deposit (at that time comprising the Central Soumber, East Soumber and Biluut Fields) with MRAM. Further, on July 6, 2011, the Company announced that MRAM had issued the Company a mining license pertaining to the Soumber Deposit. The new 10,993ha mining license was granted for an initial term of 30 years with an option for two 20 year extensions.

Resources associated with the South Biluut and Jargalant Fields have been through the resource registration process and the exploration licenses pertaining to resources outside the mining license are subject to PMA applications. Subsequent to the receipt of the PMA, the Company intends to proceed through to the mining license application process.

Environmental baseline studies have been completed and general environmental impact assessments have been approved. The Company is also studying the feasibility of building a coal preparation plant for the Soumber coal to remove rock partings and produce a hard coking coal product.

In 2011, the Company spent $7.8 million to better define and expand the existing resource at the Soumber Deposit. In 2012, the Company plans to continue exploration activities at the Soumber Deposit and complete a pre-feasibility study in the second half of 2012.

3. Results of operations continued

3.1 Mongolian coal division continued

Development projects continued

Zag Suuj Deposit

The Zag Suuj Deposit, located approximately 150km east of the Ovoot Tolgoi Mine and approximately 80km north of the Mongolia-China border, lies within the administrative units of Noyon and Bayandalai Soums in the Umnugobi Aimag (South Gobi Province).

The 2011 drilling program was aimed at establishing a maiden NI 43-101 compliant resource estimate at the Zag Suuj Deposit. Since exploration commenced in 2007, approximately 45,445m of core and reverse circulation holes have been drilled at the Zag Suuj Deposit.

Based on the exploration results to date, the coal occurrence at the Zag Suuj Deposit can be divided into four separate seams. Each of the seams split into a number of coal plies of highly variable thickness, separated by stone partings. Interburden between the seams is mainly sandstone and conglomerate, whilst partings within the seams tend to be dominated by mudstone and carbonaceous mudstone. Correlation of the coal seams at the Zag Suuj Deposit with the Ovoot Tolgoi Complex and the Soumber Deposit has not been undertaken.

Several of the seams at the Zag Suuj Deposit have an average free swell index greater than 5, indicating metallurgical properties; however, limited metallurgical testing has been undertaken to date.

On March 19, 2012, the Company reported its maiden NI 43-101 compliant independent resource estimate for the Zag Suuj Deposit prepared by MMC. MMC estimated that the Zag Suuj Deposit contains indicated coal resources of 17.0 million tonnes and inferred coal resources of 66.0 million tonnes as at December 31, 2011. The entire Zag Suuj resource is located above 300m and is amenable to surface mining. Details of the assumptions and parameters used to calculate the resources and coal quality estimates and information on data verification are set out in the Annual Information Form dated March 19, 2012, and available at www.sedar.com.

The coal rank at the Zag Suuj Deposit ranges between low to medium volatile bituminous coal based on the ASTM D388 standard. The average calorific value for individual coal seams ranges between 5,600 and 6,100 kcal/kg (ad).

The resource associated with the Zag Suuj Deposit has been through the resource registration process and the exploration licenses pertaining to it are subject to PMA applications. The 2012 exploration program will aim to better define and expand the existing resource at the Zag Suuj Deposit. It is anticipated that coals from the Zag Suuj Deposit can be washed to produce a coal coking product or a coking coal blend product. Detailed beneficiation studies are also planned to be carried out on the coal in 2012.

3. Results of operations continued

3.1 Mongolian coal division continued

Development projects continued

Ovoot Tolgoi Underground Deposit

The Ovoot Tolgoi Underground Deposit is contiguous to, and located directly below, the Ovoot Tolgoi Mine. The entire extension of the coal at depth from 300m to 600m that is designated for potential underground development is located inside the existing Ovoot Tolgoi mining license.

On March 19, 2012, the Company announced an updated NI 43-101 compliant independent resource estimate prepared by MMC. MMC estimated that the Ovoot Tolgoi Underground Deposit contains measured coal resources of 65.8 million tonnes, indicated coal resources of 43.3 million tonnes and inferred coal resources of 62.0 million tonnes as at October 31, 2011. Details of the assumptions and parameters used to calculate the resources and coal quality estimates and information on data verification are set out in the Annual Information Form dated March 19, 2012, and available at www.sedar.com.

The coal rank at the Ovoot Tolgoi Underground Deposit is high volatile B to A bituminous based on the ASTM D388 standard. High volatile B produces between 7,212 to 7,785 kcal/kg and high volatile A produces greater than 7,785 kcal/kg heat output.

The Company is currently undertaking studies to determine the feasibility and economics of conducting an underground mining operation at the Ovoot Tolgoi Underground Deposit.

Tsagaan Tolgoi Deposit

The Tsagaan Tolgoi Deposit is located in south-central Mongolia. The property is located in the Umnugobi Aimag (South Gobi Province) approximately 570km south of Ulaanbaatar and 113km southeast of the provincial capital of Dalanzadgad, and approximately 115km west of Oyu Tolgoi.

In February 2008, Norwest estimated 23.4 million tonnes of measured coal resources, 13.0 million tonnes of indicated coal resources and 9.0 million tonnes of inferred coal resources. The coal is of volatile bituminous B to C in rank based on ASTM D388 standards and is suitable for use as a thermal coal. Details of the assumptions and parameters used to calculate these coal resources and coal quality estimates are set out in the Technical Report entitled, "Coal Geology and Resources – Tsagaan Tolgoi Property" dated March 25, 2008, and available at www.sedar.com.

Effective August 12, 2009, the Government of Mongolia issued a mining license for the Tsagaan Tolgoi Deposit. The Technical and Economic Study has been completed and was approved by the Government of Mongolia on March 4, 2010. The Detailed Environmental Impact Assessment was approved on April 9, 2010.

On March 5, 2012, SouthGobi announced an agreement to sell the Tsagaan Tolgoi Deposit to Modun, a company listed on the Australian Stock Exchange under the symbol MOU. Under the transaction, SouthGobi expects to receive $30.0 million of total consideration, comprising $7.5 million up-front in cash, $12.5 million up-front in Modun shares and deferred consideration of an additional $10.0 million also payable in Modun shares.

3. Results of operations continued

3.1 Mongolian coal division continued

Development projects continued

Tsagaan Tolgoi Deposit continued

As a result, SouthGobi will have a significant shareholding in Modun and it will have the right to nominate one director to the board of Modun subject to SouthGobi holding an equity interest in excess of 14.9%. The transaction is subject to Modun shareholder approval, regulatory approvals under the laws of Mongolia, Hong Kong and Singapore, and Australian Foreign Investment Review Board approval. The transaction is expected to be completed by June 1, 2012.

Investments

Aspire (19.9% owned)

As at December 31, 2011, SouthGobi owned 19.9% of Aspire, a company listed on the Australian Stock Exchange under the symbol AKM. Aspire's primary focus is its mineral exploration licenses in Mongolia, particularly those pertaining to the Ovoot Coking Coal Project. The Company's interest in Aspire was primarily acquired through a placement in December 2010 whereby SouthGobi acquired a 19.9% interest in Aspire for $20.3 million. On October 12, 2011, Aspire completed a private placement issuing 80 million additional common shares. SouthGobi participated in the placement, exercising its right to maintain its 19.9% ownership interest. As at March 16, 2012, SouthGobi has invested a total of $27.9 million in Aspire and its interest in Aspire had a market value of $43.2 million.

In a press release dated October 14, 2010, Aspire announced a maiden JORC compliant coal resource with an estimated 93.3 million tonnes of measured coal resources, 182.4 million tonnes of indicated coal resources plus an additional 55.0 million tonnes of inferred coal resources for the Ovoot Coking Coal Project. In a press release dated April 6, 2011, Aspire announced that it had received the raw coal quality sample analyses from its 2010 drilling program. The raw coal tests results show a coal type of Raw Coking Coal Quality (in situ) with: Inherent Moisture – 0.6%, Ash – 19.5%, Volatiles – 26.5%, Sulphur – 1.2%, Crucible Swelling Index – 7.7 and Energy – 6,668 kcal/kg. Data results are on an air dried basis for raw coal samples. Based on the samples tested, it is expected that the Ovoot Coking Coal Project washed product will be a high fluidity, high volatile B bituminous coking coal. Subsequently, in a press release dated June 24, 2011, Aspire announced coal washability test results confirming theoretical 80% yields at 8% ash content.

In a press release dated January 20, 2012, Aspire announced that a pre-feasibility study is being completed for the Ovoot Coking Coal Project regarding the development of a 15 million tonne per annum ROM open pit mine. An updated reserve and resource estimate is also being prepared.

Exploration program

The 2011 exploration program included further drilling of prospective greenfields exploration properties, as well as the broader Ovoot Tolgoi Complex and the Soumber Deposit, together with water exploration and geological reconnaissance.

In 2011, SouthGobi conducted a record level of exploration activity in Mongolia. The Company spent $31.8 million on exploration, primarily consisting of drilling, geophysics, license fees, salaries and overheads, which includes share-based compensation, compared to $18.8 million in 2010. In 2011, the Company drilled 120,267m (both core and reverse circulation). The 2011 exploration program also included a more active water exploration program. The Company has identified potential water resources and is currently preparing pre-feasibility studies for these resources.

3. Results of operations continued

3.1 Mongolian coal division continued

Exploration program continued

The 2011 drilling program focused primarily on further definition of known coal occurrences with the intention to bring them to a NI 43-101 compliant resource definition stage and to allow for registration with the Government of Mongolia as the next step towards expanding the Company's mining license holdings.

On March 19, 2012, the Company announced a substantial resource upgrade as a result of its 2011 exploration program. The Company increased its resource base by 32.0 million tonnes of measured coal resources, 97.0 million tonnes of indicated coal resources and 72.1 million tonnes of inferred coal resources.

3.2 Administrative and other

Administration expense consists of corporate administration, legal and professional fees, salaries and benefits, share-based compensation and depreciation (see Note 7 of the consolidated financial statements). Administration expenses increased from $25.4 million in 2010 to $28.7 million in 2011. The increase primarily relates to increased share-based compensation expense and additional staff to support the expansion of the Company's operations.

Other operating expenses include items SouthGobi considers to be related to the operation of its business. Other operating expenses consist of public infrastructure costs, sustainability and community relations costs, foreign exchange gains/losses, provisions for doubtful trade and other receivables, impairment of inventories and impairment of property, plant and equipment (see Note 6 of the consolidated financial statements). Other operating expenses increased from $12.6 million in 2010 to $29.2 million in 2011. The increase primarily relates to the impairment of property, plant and equipment and public infrastructure costs.

In 2011, the Company recorded $16.6 million of impairment charges, net of insurance proceeds receivable, to reduce various items of property, plant and equipment to their recoverable amounts. The impairments relate to the following items of property, plant and equipment:

- Liebherr 996 hydraulic shovel – the Liebherr 996 hydraulic shovel was damaged in a fire and an impairment charge of $11.1 million was recorded to derecognize the full carrying amount of the asset and its related capital spares. The Company recorded net insurance proceeds of $12.9 million in trade and other receivables, which resulted in a gain of $1.8 million.
- Terex TR100 haul trucks – the Terex TR100 haul trucks are expected to be replaced in 2012 with larger and more efficient haul trucks. The Company recorded an impairment charge of $2.5 million to reduce their carrying amount to their estimated recoverable amount.
- Construction in progress – various capitalized construction projects were reviewed for impairment and it was determined that certain costs associated with these projects were not expected to be recovered. These construction projects included expenditures on mine access roads and infrastructure and mine infrastructure feasibility study costs. The Company recorded an impairment charge of $16.0 million to reduce the carrying amount of these construction projects to $nil.

3. Results of operations continued

3.2 Administrative and other continued

The impairment of property, plant and equipment does not impact the Company's continuing operations.

In 2010, the Company decided to replace its Liebherr 994 shovel to increase fleet flexibility and recorded an impairment charge of $1.8 million to reduce its carrying amount to its recoverable amount.

Public infrastructure costs increased by $2.1 million in 2011 compared to 2010. These costs relate to maintenance and upgrading of public transportation infrastructure used to transport coal from the Ovoot Tolgoi Mine to the Shivee Khuren Border Crossing and work completed on the Mongolian side of the border to facilitate the future opening of the designated coal transportation corridors at the Shivee Khuren Border Crossing.

4. Summary of quarterly results

($ in thousands, except per share information unless otherwise indicated)

	2011				2010			
Quarter ended	**31-Dec**	**30-Sep**	**30-Jun**	**31-Mar**	31-Dec	30-Sep	30-Jun	31-Mar
Revenue	**$51,064**	**$60,491**	**$47,336**	**$20,158**	$41,595	$6,597	$17,668	$13,917
Gross profit	**16,637**	**17,635**	**9,744**	**7,690**	3,950	336	4,400	1,187
Profit margin	**33%**	**29%**	**21%**	**38%**	9%	5%	25%	9%
Other operating expenses	**(24,644)**	**(138)**	**(3,024)**	**(1,383)**	(2,121)	(7,586)	(1,894)	(1,042)
Administration expenses	**(8,612)**	**(7,993)**	**(6,808)**	**(5,336)**	(6,599)	(7,405)	(6,442)	(4,992)
Evaluation and exploration expenses	**(14,513)**	**(10,908)**	**(4,356)**	**(1,991)**	(4,144)	(6,314)	(6,659)	(1,651)
Loss from operations	**(31,132)**	**(1,404)**	**(4,444)**	**(1,020)**	(8,914)	(20,969)	(10,595)	(6,498)
Net income/(loss)	**(18,897)**	**55,921**	**67,323**	**(46,602)**	(28,720)	27,495	53,301	(168,271)
Basic income/(loss) per share	**(0.10)**	**0.31**	**0.37**	**(0.25)**	(0.16)	0.15	0.29	(1.09)
Diluted loss per share	**(0.14)**	**(0.02)**	**–**	**(0.25)**	(0.16)	(0.08)	(0.07)	(1.09)

4. Summary of quarterly results continued

($ in thousands, except per share information unless otherwise indicated)

	2011				2010			
Quarter ended	**31-Dec**	**30-Sep**	**30-Jun**	**31-Mar**	31-Dec	30-Sep	30-Jun	31-Mar
Volumes and prices								
Raw semi-soft coking coal								
Raw coal production *(millions of tonnes)*	**0.47**	**0.55**	**0.52**	**0.48**	0.41	0.18	0.39	0.21
Coal sales *(millions of tonnes)*	**0.53**	**0.66**	**0.60**	**0.34**	0.35	0.11	0.42	0.40
Average realized sales price *(per tonne)*	**$67.62**	**$66.83**	**$65.96**	**$56.50**	$47.08	$46.04	$44.10	$36.62
Raw medium-ash coal								
Raw coal production *(millions of tonnes)*	**0.37**	**0.20**	**–**	**–**	–	–	–	–
Coal sales *(millions of tonnes)*	**0.37**	**0.20**	**–**	**–**	–	–	–	–
Average realized sales price *(per tonne)*	**$48.59**	**$48.17**	**$–**	**$–**	$–	$–	$–	$–
Raw higher-ash coal								
Raw coal production *(millions of tonnes)*	**0.50**	**0.50**	**0.35**	**0.63**	0.97	0.39	0.23	0.01
Coal sales *(millions of tonnes)*	**0.25**	**0.51**	**0.45**	**0.11**	1.12	0.08	0.03	0.03
Average realized sales price *(per tonne)*	**$40.30**	**$39.74**	**$38.32**	**$31.68**	$26.75	$25.34	$18.82	$21.24
Total								
Raw coal production *(millions of tonnes)*	**1.34**	**1.25**	**0.87**	**1.11**	1.38	0.57	0.62	0.22
Coal sales *(millions of tonnes)*	**1.15**	**1.37**	**1.05**	**0.45**	1.47	0.19	0.45	0.43
Average realized sales price *(per tonne)*	**$55.51**	**$54.01**	**$54.06**	**$50.29**	$31.56	$37.15	$42.63	$35.52
Costs								
Direct cash costs of product sold *(per tonne)* [(i)]	**$22.14**	**$22.64**	**$26.77**	**$18.91**	$18.53	$18.59	$21.37	$22.25
Total cash costs of product sold *(per tonne)* [(i)]	**$23.09**	**$23.17**	**$27.61**	**$20.61**	$19.25	$22.04	$22.30	$23.32
Waste movement and stripping ratio								
Production waste material moved *(millions of bank cubic meters)*	**4.58**	**4.10**	**4.08**	**3.85**	3.56	2.90	1.73	1.50
Strip ratio *(bank cubic meters of waste rock per tonne of coal produced)*	**3.42**	**3.28**	**4.74**	**3.47**	2.58	5.09	2.79	6.79
Pre-production waste material moved *(millions of bank cubic meters)*	**–**	**0.39**	**0.80**	**0.49**	0.73	0.43	0.02	–
Other operating capacity statistics								
Capacity								
Number of mining shovels/excavators available at period end	**3**	**3**	**4**	**3**	3	2	2	2
Total combined stated mining shovel/ excavator capacity at period end *(cubic meters)*	**64**	**64**	**98**	**83**	82	48	48	48
Number of haul trucks available at period end	**25**	**16**	**16**	**16**	15	12	11	9
Total combined stated haul truck capacity at period end *(tonnes)*	**4,561**	**2,599**	**2,599**	**2,599**	2,254	1,727	1,509	1,073
Employees and safety								
Employees at period end	**720**	**695**	**658**	**600**	544	472	421	388
Lost time injury frequency rate [(ii)]	**1.2**	**0.9**	**0.6**	**0.7**	0.8	0.9	1.0	0.6

(i) A non-IFRS financial measure, see Section 5

(ii) Per 1,000,000 man hours

4. Summary of quarterly results continued

The changes in comparative results of operations on a quarter over quarter basis are due primarily to fluctuations in the following areas:

Coal production increased slightly in the fourth quarter of 2011 compared to the third quarter of 2011, despite the loss of the Liebherr 996 hydraulic shovel in September 2011. The second Liebherr R9250 hydraulic excavator, which was commissioned ahead of schedule in the second quarter of 2011 and previously used to supplement mining capacity of the Company's existing fleet, enabled the Company to meet its production targets for the fourth quarter of 2011.

The Company recognized revenue of $51.1 million compared to $60.5 million in the third quarter of 2011 and $41.6 million in the fourth quarter of 2010. Sales volume declined in the fourth quarter of 2011 compared to the third quarter of 2011 due to some customers' preference to purchase coal on a washed basis in 2012 in lieu of taking unwashed coal during the fourth quarter of 2011 and management's decision to stockpile a manageable amount of coal for processing in 2012. The Company sold 1.15 million tonnes at an average realized selling price of $55.51 per tonne compared to 1.37 million tonnes at an average realized price of $54.01 per tonne in the third quarter of 2011 and 1.47 million tonnes at an average realized selling price of $31.56 per tonne in the fourth quarter of 2010.

Revenue continues to be negatively impacted by the current royalty regime. The 'effective royalty' rate increased from 16% in the third quarter of 2011 to 18% in the fourth quarter of 2011 due to the methodology being applied to royalties basing fees on reference price levels set arbitrarily by the Government of Mongolia. The reference price levels applied to the Company's raw semi-soft coking coal and raw medium-ash coal were identical, despite the lower realized selling price for the Company's raw medium-ash coal.

Together with other Mongolian mining companies affected by the escalation of effective royalty rates, a dialog was opened on this topic with the appropriate Government of Mongolia authorities with a view to moving to a more equitable process for setting reference prices. There has been a successful outcome in that commencing February 2012 royalty reference prices are now based off prices for coal products sold at the two main coal export border locations in Mongolia, namely Shivee Khuren-Ceke and Gashuun Sukhait-Ganqimaodao. The dialog is continuing, with the aim of having prices based off actual contract prices for sales at these locations, excluding export fees and Chinese VAT (i.e. revenue received for coal delivered to the Mongolia-China border prior to export).

Cost of sales was $34.4 million in the fourth quarter of 2011 compared to $42.9 million in the third quarter of 2011 and $37.6 million in the fourth quarter of 2010. Cost of sales comprise the direct cash costs of product sold, mine administration cash costs of product sold, equipment depreciation, depletion of mineral properties and share-based compensation. Cost of sales decreased in the fourth quarter of 2011 compared to the third quarter of 2011 and the fourth quarter of 2010 due to lower sales volumes. The lower sales volumes in the fourth quarter of 2011 were partially offset by higher unit costs compared to the fourth quarter of 2010.

Direct cash costs of product sold were $22.14 per tonne in the fourth quarter of 2011 compared to $22.64 per tonne in the third quarter of 2011 and $18.53 per tonne in the fourth quarter of 2010. Direct cash costs per tonne sold increased in the fourth quarter of 2011 compared to the fourth quarter of 2010 primarily due to an increase in the strip ratio partially offset by mining efficiencies.

Gross profit decreased marginally to $16.6 million in the fourth quarter of 2011 from $17.6 million in the third quarter of 2011; however, the profit margin increased to 33% in the fourth quarter of 2011 compared to 29% in the third quarter of 2011 due to an improved sales mix and higher selling prices for individual coal types. This compares to a $4.0 million gross profit and 9% profit margin in the fourth quarter of 2010. Gross profit will vary by quarter depending on sales volume, sales price and unit costs.

4. Summary of quarterly results continued

Other operating expenses consist of public infrastructure costs, sustainability and community relations costs, foreign exchange gains/losses, provisions for doubtful trade and other receivables, impairment of inventories and impairment of property, plant and equipment (see Note 6 of the consolidated financial statements). Other operating expenses increased to $24.6 million in the fourth quarter of 2011, compared to $0.1 million in the third quarter of 2011 and $2.1 million in the fourth quarter of 2010. The increase in the fourth quarter of 2011 primarily relates to the following items:

- $19.5 million of impairment charges to reduce the carrying amount of the Terex TR100 haul trucks and various construction in progress projects to their recoverable amounts (refer to section 3.2 for details)
- A $2.4 million impairment of materials and supplies inventory related to the Company's Liebherr 996 hydraulic shovel and other mobile equipment derecognized during the year
- A $1.9 million loss provision on one uncollectible trade receivable

The impairment charges and loss provision recorded in the fourth quarter of 2011 do not impact the Company's continuing operations.

Administration costs for the fourth quarter of 2011 were $8.6 million compared to $8.0 million in the third quarter of 2011 and $6.6 million in the fourth quarter of 2010. The increased administration costs for the fourth quarter of 2011 compared to the third quarter of 2011 primarily relates to employee bonuses. The increased administration costs for the fourth quarter of 2011 compared to the fourth quarter of 2010 primarily relates to increased share-based compensation expense and additional staff to support the expanded operations.

Exploration expenses for the fourth quarter of 2011 were $14.5 million compared to $10.9 million for the third quarter of 2011 and $4.1 million for the fourth quarter of 2010. Exploration expenses will vary from quarter to quarter depending on the number of projects and the related seasonality of the exploration programs. Exploration in 2011 was delayed due to delays in receiving required government approvals, resulting in a higher proportion of costs being incurred in the third and fourth quarters of 2011. In addition, the 2011 exploration program included a more active water exploration program.

The Company recorded a net loss for the three months ended December 31, 2011 of $18.9 million compared to net income of $55.9 million for the three months ended September 30, 2011 and a net loss of $28.7 million for the three months ended December 31, 2010. The net loss in the fourth quarter of 2011 primarily relates to gross profit less other operating expenses, administration costs and exploration expenses, partially offset by a $10.8 million gain on the fair value change of the embedded derivatives in the CIC convertible debenture. The fair value of the embedded derivatives is driven by many factors including: share price, foreign exchange rates and share price volatility. The share price decreased from Cdn$6.65 at September 30, 2011 to Cdn$6.00 at December 31, 2011 resulting in a decrease in the fair value of the embedded derivatives and contributed to the gain of $10.8 million. The $10.8 million gain in the fourth quarter of 2011 compares to a gain of $62.1 million in the third quarter of 2011 and a loss of $20.0 million in the fourth quarter of 2010 on the fair value change of the embedded derivatives in the CIC convertible debenture.

Adjusted net loss (a non-IFRS financial measure, see Section 5) was $1.6 million in the fourth quarter of 2011, compared to $2.2 million in the third quarter of 2011 and $10.5 million in the fourth quarter of 2010. Adjusted net loss decreased compared to the fourth quarter of 2010 primarily due to increased gross profit as a result of increased sales volumes and expanding product margins and lower interest expense, offset by higher exploration expenses.

4. Summary of quarterly results continued

	2011			
Quarter ended	**31-Dec**	**30-Sep**	**30-Jun**	**31-Mar**
Net income/(loss)	**$(18,897)**	**$55,921**	**$67,323**	**$(46,602)**
Income/(loss) adjustments, net of tax				
Share-based compensation	**4,050**	**4,296**	**3,349**	**2,715**
Net impairment loss/(recovery) on assets	**23,818**	**(2,925)**	**–**	**–**
Unrealized foreign exchange losses/(gains)	**34**	**103**	**263**	**(993)**
Loss/(gain) on value change of embedded derivatives in CIC debenture	**(10,790)**	**(62,058)**	**(70,422)**	**36,780**
Loss on partial conversion of CIC debenture	**–**	**–**	**–**	**–**
Loss/(gain) on FVTPL investments	**155**	**2,449**	**(3,629)**	**4,116**
Adjusted net loss (i)	**(1,630)**	**(2,214)**	**(3,116)**	**(3,984)**

	2010			
Quarter ended	31-Dec	30-Sep	30-Jun	31-Mar
Net income/(loss)	$(28,720)	$27,495	$53,301	$(168,271)
Income/(loss) adjustments, net of tax				
Share-based compensation	3,840	3,695	2,754	2,971
Net impairment loss/(recovery) on assets	574	7,010	–	–
Unrealized foreign exchange losses/(gains)	(1,837)	(1,116)	(1,120)	370
Loss/(gain) on value change of embedded derivatives in CIC debenture	19,995	(49,772)	(72,232)	1,372
Loss on partial conversion of CIC debenture	–	–	–	151,353
Loss/(gain) on FVTPL investments	(4,375)	(1,735)	4,555	685
Adjusted net loss (i)	(10,523)	(14,423)	(12,742)	(11,520)

(i) A non-IFRS financial measure, see Section 5

5. Non-IFRS financial measures

($ in thousands, unless otherwise stated)

The Company has included certain non-IFRS financial measures including "cash costs" and "adjusted net income/(loss)" to supplement its Consolidated Financial Statements, which are presented in accordance with IFRS.

The Company believes that these measures, together with measures determined in accordance with IFRS, provide investors with useful information to evaluate the underlying performance of the Company. Non-IFRS financial measures do not have a standardized meaning prescribed under IFRS and therefore may not be comparable to similar measures employed by other companies. The data is intended to provide additional information and should not be considered in isolation or as substitute for measures of performances prepared in accordance with IFRS.

Cash costs

The Company uses cash costs to describe its cash production costs. Cash costs incorporate all production costs, which include direct and indirect costs of production. Non-cash adjustments include share-based compensation costs, depreciation and depletion of mineral properties.

The Company uses this performance measure to monitor its operating cash costs internally and believes this measure provides investors and analysts with useful information about the Company's underlying cash costs of operations. The Company believes that conventional measures of performance prepared in accordance with IFRS do not fully illustrate the ability of its mining operations to generate cash flows. The Company reports cash costs on a sales basis. This performance measure is commonly utilized in the mining industry.

5. Non-IFRS financial measures continued

The cash costs of product sold presented below may differ from cash costs of product produced depending on the timing of stockpile inventory turnover.

	Year ended December 31,	
	2011	2010
Cash costs		
Cost of sales per financial statements	**$127,343**	$69,904
Less non-cash expenses	**(30,808)**	(17,419)
Total cash costs	**96,535**	52,485
Coal sales *(000's of tonnes)*	**4,021**	2,536
Total cash costs of product sold *(per tonne)*	**$24.01**	$20.70

	Year ended December 31,	
	2011	2010
Cash costs		
Direct cash costs of product sold *(per tonne)*	**$23.15**	$19.66
Mine administration cash costs of product sold *(per tonne)*	**0.86**	1.04
Total cash costs of product sold *(per tonne)*	**$24.01**	$20.70

Adjusted net income/(loss)

Adjusted net income/(loss) excludes share-based compensation, net impairment loss/ (recovery) on assets, unrealized foreign exchange losses/(gains), loss/(gain) on the fair value change of the embedded derivatives in the CIC convertible debenture, loss on partial conversion of the CIC convertible debenture, losses/(gains) on fair value through profit or loss ("FVTPL") investments and loss from discontinued operations. The Company excludes these items from net income/(loss) to provide a measure which allows the Company and investors to evaluate the results of the underlying core operations of the Company and its profitability from operations. The items excluded from the computation of adjusted net income/(loss), which are otherwise included in the determination of net income/(loss) prepared in accordance with IFRS, are items that the Company does not consider to be meaningful in evaluating the Company's past financial performance or the future prospects and may hinder a comparison of its period-to-period results.

	Year ended December 31,		
	2011	2010	2009
Net income/(loss)	**$57,745**	$(116,195)	$(110,805)
Income/(loss) adjustments, net of tax			
Share-based compensation	**14,410**	13,260	12,195
Net impairment loss on assets	**20,893**	7,584	–
Unrealized foreign exchange losses/(gains)	**(593)**	(3,703)	1,213
Loss/(gain) on value change of embedded derivatives in CIC debenture	**(106,489)**	(100,637)	44,980
Loss on partial conversion of CIC debenture	**–**	151,353	–
Loss/(gain) on FVTPL investments	**3,091**	(870)	(843)
Loss from discontinued operations	**–**	–	31,088
Adjusted net loss	**$(10,943)**	$(49,208)	$(22,172)

6. Finance income/(costs)

($ in thousands)

	Year ended December 31,	
	2011	2010
Fair value gain on embedded derivatives in convertible debenture	**$106,489**	$100,637
Loss on partial conversion of convertible debenture	**–**	(151,353)
Interest expense on convertible debenture	**(9,137)**	(24,294)
Interest expense on line of credit facility	**(351)**	(131)
Mark to market gain/(loss) on FVTPL investments	**(3,091)**	870
Accretion of decommissioning liability	**(186)**	(77)
Interest income	**1,243**	2,441
	$94,967	$(71,907)

In November 2009, the Company entered into a financing agreement with a wholly owned subsidiary of CIC for $500 million in the form of a secured, convertible debenture bearing 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 convertible debenture is a hybrid debt instrument, containing a debt host component and embedded derivatives. The debt host is measured at amortized cost using the effective interest method. The embedded derivatives are measured at fair value and all changes in fair value are recognized in profit or loss immediately.

Pursuant to the debenture conversion terms, the Company had the right to call for the conversion of up to $250 million of the debenture upon achieving a public float of 25% of its common shares based on a conversion price of the lower of Cdn$11.88 and the 50-day volume-weighted average price ("VWAP"). On March 29, 2010, the Company exercised this right and completed the conversion of $250 million of the convertible debenture into 21.5 million shares at a conversion price of $11.64 (Cdn$11.88). On March 29, 2010, the Company also settled all the accrued interest payable in shares on the converted $250 million by issuing 0.1 million shares for the $1.4 million in accrued interest converted at the 50-day VWAP conversion price of $15.97 (Cdn$16.29). On April 1, 2010, the Company also settled the outstanding accrued interest payable in cash on the converted $250 million with a cash payment of $5.7 million.

For the year ended December 31, 2011, the fair value change of the embedded derivatives in the CIC convertible debenture resulted in a gain of $106.5 million, compared to a gain of $100.6 million for the year ended December 31, 2010. The fair value of the embedded derivatives is driven by many factors including: share price, foreign exchange rates and share price volatility. The share price decreased from Cdn$12.18 at December 31, 2010 to Cdn$6.00 at December 31, 2011 resulting in a decrease in the fair value of the embedded derivatives and contributed to the gain of $106.5 million. Finance costs for year ended December 31, 2010 include a $151.4 million loss on partial conversion of the convertible debenture. The partial conversion contributed to the decreased interest expense on the convertible debenture, $9.1 million in 2011 compared to $24.3 million in 2010. In 2011, the Company also capitalized $10.9 million of interest as borrowing costs.

6. Finance income/(costs) continued

On January 18, 2011, the Company signed a new revolving line of credit facility with Golomt Bank for a twelve month period. Under the new agreement the maximum draw-down available is $3.5 million and MNT8.1 billion (approximately $5.8 million) and bears interest at 11% for any U.S. Dollar amounts outstanding and 12% for any Mongolian Tugrik amounts outstanding. The line of credit facility is used by the Company's Mongolian subsidiaries as part of their working capital management. The Company incurred interest expense related to the line of credit of $0.4 million for the year ended December 31, 2011 (2010: $0.1 million). The line of credit facility was renewed with the same terms on January 19, 2012.

The Company recorded a mark to market loss on FVTPL investments of $3.1 million for the year ended December 31, 2011 compared to a gain of $0.9 million in the same period in 2010. Included in the mark to market gain/loss is the mark to market adjustment on the Company's investment in Kangaroo and certain money market instruments.

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

Interest income was lower for the year ended December 31, 2011 compared to the same period in 2010 due to lower cash balances. The current economic climate has also resulted in very low interest rates, especially for U.S. Dollar denominated investments.

7. Taxes

For the year ended December 31, 2011, the Company recorded current income tax expense of $7.3 million related to its Mongolian operations compared to $1.8 million for the year ended December 31, 2010. The Company has recorded a deferred income tax recovery related to deductible temporary differences of $8.1 million (2010: $4.5 million) for the year ended December 31, 2011.

8. Liquidity and capital resources

Consistent with the Company's overall capital management strategy, the Company continues to have sufficient liquidity and capital resources to meet its ongoing obligations and future contractual commitments and to finance its growth strategies. In the near term, the Company expects its liquidity to remain strong based on residual proceeds from the CIC convertible debenture offering and proceeds from the global equity offering, as well as increasing cash flows from operations due to higher forecast production levels and stable coal prices. The Company has in place a planning, budgeting and forecasting process to help determine the funds required to support the Company's normal operations on an ongoing basis and its expansionary plans. Factors that could impact the Company's liquidity are monitored regularly and include but are not limited to Chinese economic growth, market prices of coal, production levels, operating cash costs, capital costs, exchange rates of currencies of countries where the Company operates, exploration and discretionary expenditures. As at December 31, 2011, the Company is not subject to any externally imposed capital requirements.

In November 2009, the Company entered into a financing agreement with a wholly owned subsidiary of the CIC for $500 million in the form of a secured, convertible debenture bearing interest at 8.0% with a maximum term of 30 years. The convertible debenture is secured by a charge over the Company's assets and certain subsidiaries. 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.

8. Liquidity and capital resources continued

On March 29, 2010, the Company exercised its right to call for the conversion of up to $250 million of the convertible debenture into 21.5 million shares at a conversion price of $11.64 (Cdn$11.88). At December 31, 2011, the CIC owned through its indirect wholly owned subsidiary approximately 14% of the Company.

On January 29, 2010, the Company announced that it had closed the global equity offering of 27.0 million common shares of the Company at a price of Cdn$17.00 per common share, for gross proceeds of $437.4 million. On February 26, 2010, the Company announced a partial exercise of the over-allotment option and issued an additional 0.2 million common shares of the Company at a price of Cdn$17.00 per share for gross proceeds of $3.7 million.

At the time of the financing, the Company planned to use the net proceeds from the financings above to carry out the following activities:

- Expansion of the production capacity at the Company's Ovoot Tolgoi Mine
- Assessment, construction and development of regional transportation infrastructure
- Assessment and construction of value added facilities such as a coal-handling facility and a washing plant
- Exploration and development of the Soumber Deposit
- General exploration, development and acquisition activities
- Working capital, general and administrative expenses and other general corporate purposes

To date, the Company's actual use of such proceeds has not varied from the anticipated use of proceeds at the time of the financing.

At December 31, 2011, the Company had cash and cash equivalents of $123.6 million and long term money market investments of $45.0 million for a total of $168.6 million in cash and cash equivalents and money market investments compared to cash and cash equivalents of $492.0 million and short and long term money market investments of $62.7 million for a total of $554.7 million in cash and cash equivalents and money market investments at December 31, 2010.

Working capital (excess current assets over current liabilities) was $236.1 million at December 31, 2011 compared to $545.8 million at December 31, 2010 representing a decrease of 57%. The decrease in working capital primarily relates to $283.0 million of property, plant and equipment purchases required to support the expansion of mining operations at the Ovoot Tolgoi Mine and $33.1 million of common share repurchases.

Trade receivables and other receivables increased to $80.3 million at December 31, 2011 compared to $30.2 million at December 31, 2010. The Company closely monitors collectability of outstanding accounts receivable for current coal sales. The Company sells to recognized, creditworthy third parties and expects to collect all outstanding receivables. However, unforeseen unfavorable market conditions could have an impact on future collectability.

Effective November 10, 2010, the Government of Mongolia issued the list defining finished mineral products. Based on that list, the Company's current coal products do not qualify as finished mineral products. When the Company completes the upgrade of the DCHF to include the dry air separation modules, its coal products should qualify as finished mineral products and from that point forward the Company will once again be eligible to reclaim any paid VAT amounts. The upgrade of the DCHF is scheduled to be fully commissioned by the fourth quarter of 2012.

At December 31, 2011, the non-current portion of the CIC convertible debenture was $139.1 million compared to $245.5 million at December 31, 2010. In 2011, the decrease in the fair value of the embedded derivatives in the CIC convertible debenture resulted in a gain of $106.5 million.

8. Liquidity and capital resources continued

Cash flow highlights

($ in thousands)

	Year ended December 31,	
	2011	2010
Cash used in operating activities	**$(70,023)**	$(57,848)
Cash used in investing activities	**(270,432)**	(217,705)
Cash (used in)/generated by financing activities	**(27,574)**	409,342
Effect of foreign exchange rate changes on cash	**(442)**	907
(Decrease)/increase in cash for the period	**(368,471)**	134,696
Cash balance, beginning of the period	**492,038**	357,342
Cash balance, end of the period	**$123,567**	$492,038

Cash used in operating activities

Cash used in operations for the year ended December 31, 2011 was $70.0 million compared to $57.8 million for the year ended December 31, 2010. The increased outflows in 2011 primarily related to increased working capital requirements partially offset by increased cash flow from the Company's mine operations.

Cash used in investing activities

Cash used in investing activities was $270.4 million for the year ended December 31, 2011 compared to $217.7 million for the year ended December 31, 2010 primarily due to increased purchases of property, plant and equipment of $83.2 million offset by increased maturities of short and long term investments of $17.5 million and decreased purchases of long term investments of $12.7 million.

In 2011, the increase in expenditures related to the purchase of property, plant and equipment to support the expansion of mining operations at the Ovoot Tolgoi Mine. Further, subsequent to the first quarter of 2011, maturing money market investments were not reinvested to support the Company's funding requirements.

Cash used in financing activities

Cash used in financing activities was $27.6 million for the year ended December 31, 2011 compared to cash generated from financing activities of $409.3 million for the year ended December 31, 2010.

In 2011, the Company repurchased $33.1 million of its common shares. This amount was partially offset by the $5.4 million received from the exercise of share options.

On January 18, 2011, the Company signed a new revolving line of credit facility with Golomt Bank for a twelve month period. The line of credit facility is secured by a charge over certain equipment held by SouthGobi Sands LLC. The line of credit facility is used by the Company's subsidiaries as part of its working capital management. Under the agreement the maximum draw-down available is $3.5 million and MNT8.1 billion (approximately $5.8 million) and bears interest at 11% for any U.S. Dollar amounts outstanding and 12% for any Mongolian Tugrik amounts outstanding. There were no amounts due under the line of credit facility at both December 31, 2011 and December 31, 2010. The line of credit facility was renewed with the same terms on January 19, 2012.

8. Liquidity and capital resources continued

Contractual obligations and guarantees

($ in thousands)

Day-to-day mining, expansionary and sustaining capital expenditures as well as administrative operations give rise to commitments for future minimum payments. Management is of the view that such commitments will be sufficiently funded by current working capital, future operating cash flows and available lines of credit. At December 31, 2011, the Company's operating and capital commitments were:

	As at December 31, 2011			
	Within 1 year	**2-3 years**	**Over 3 years**	**Total**
Capital expenditure commitments	**$70,322**	**$–**	**$–**	**$70,322**
Operating expenditure commitments	**18,416**	**276**	**–**	**18,692**
Commitments	**$88,738**	**$276**	**$–**	**$89,014**

Share repurchase program

On June 8, 2010, the Company announced that its Board of Directors authorized a share repurchase program to purchase up to 2.5 million common shares of the Company on each or either of the TSX and the HKEX, in aggregate representing up to 5.0 million common shares of the Company. On June 8, 2011, the Company announced the renewal of its share repurchase program. The share repurchase program will remain in effect until June 14, 2012, or until the purchases are complete or the program is terminated by the Company. As of March 19, 2012, the Company had repurchased 1.6 million shares on the HKEX and 2.6 million shares on the TSX for a total of 4.2 million common shares. The Company cancels all shares after they are repurchased.

As at December 31, 2011, the Company's gearing ratio was 0.16 (December 31, 2010: 0.26), which was calculated based on the Company's long term liabilities to total assets.

Financial instruments

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 amortized cost in the financial statements approximates their fair value.

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 Kangaroo, Aspire and its money market investments are determined using this methodology. The Company's investment in shares of Kangaroo and its money market investments are classified as FVTPL. The Company's investment in the shares of Aspire is classified as available-for-sale.

The fair value of the embedded derivatives within the CIC convertible debenture was determined using a Monte Carlo simulation. The risks associated with the CIC convertible debenture relate to a potential breach of the Company's obligations under the terms of the CIC convertible debenture. The Company mitigates these risks by ensuring its corporate activities comply with all of its contractual obligations under the CIC convertible debenture.

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.

8. Liquidity and capital resources continued

	As at December 31,	
	2011	2010
Financial assets ($ in thousands)		
Loans-and-receivables		
Cash and cash equivalents	**$123,567**	$492,038
Trade and other receivables	**80,285**	30,246
Available-for-sale		
Investment in Aspire	**46,837**	52,008
Fair value through profit and loss		
Investment in Kangaroo	**7,431**	10,235
Money market investments	**44,967**	62,702
Total financial assets	**$303,087**	$647,229
Financial liabilities ($ in thousands)		
Fair value through profit and loss		
Convertible debenture – embedded derivatives	**$48,389**	$154,877
Other-financial-liabilities		
Trade and other payables	**52,235**	24,137
Convertible debenture – debt host	**96,997**	96,933
Total financial liabilities	**$197,621**	$275,947

The net gain for the year ended December 31, 2011 included the following amounts of unrealized gains/(losses) from the fair value adjustments to certain financial instruments which are classified as FVTPL:

	Year ended December 31,	
($ in thousands)	**2011**	2010
Unrealized gains/(losses) on investments	**$(3,091)**	$870
Fair value gain on embedded derivatives	**106,489**	100,637

Other comprehensive income includes an unrealized after tax loss of $11.2 million for the year ended December 31, 2011 and an after tax unrealized gain of $27.8 million gain for the year ended December 31, 2010.

9. Environment

The Company is subject to the Environmental Protection Law of Mongolia (the "EPL") and has the following duties with respect to environmental protection:

- To comply with the EPL and the decisions of the government, local self-governing organizations, local governors and Mongolian state inspectors;
- To comply with environmental standards, limits, legislation and procedures and to supervise their implementation within their organization;
- To keep records on toxic substances, adverse impacts, and waste discharged into the environment; and
- To report on measures taken to reduce or eliminate toxic chemicals, adverse impacts, and waste.

9. Environment continued

In addition to those duties imposed on them by the EPL, mining license holders are required to prepare an initial environmental impact assessment analysis before the mine comes into production. The mining license holders must also annually develop and implement an environmental protection plan (including reclamation measures) in co-operation with the Ministry of Environment, which should take into account the results of the environmental impact assessment. The Company received approval of its detailed Environmental Impact Assessment and Environmental Protection Plan from the Mongolian Ministry of Nature and Environment for the mining operation at the Ovoot Tolgoi Mine in 2007.

The Company has implemented a number of internal policies to embrace responsibility for the impact of its business activities on the environment. By conducting studies, carefully designing mine plans, implementing pollution control recommendations from internal and external sources, monitoring the effects of mining on mining areas and carefully designing mine closure plans, the Company seeks to minimize the impact of its activities on the environment.

The Company established an environmental policy in 2008. The environmental policy affirms the Company's commitment to environmental protection. The Company monitors its operations to ensure that it complies with all applicable environmental requirements, and takes actions to prevent and correct problems if needed.

The Board maintains a Health, Environment, Safety and Social Responsibility Committee. The Committee is composed of independent and non-independent directors. The primary objective of the Health, Environment, Safety and Social Responsibility Committee is to review and oversee the Company's established health, environmental, safety and social responsibility policies and procedures at the Company's project sites. The Committee also reviews any incidents that may occur and provides guidance on how to prevent any recurrences.

Decommissioning liabilities result from the acquisition, development, construction and ordinary operation of mining property, plant and equipment, and from environmental regulations set by regulatory authorities. The decommissioning liability includes costs related to removal and/or demolition of mine equipment, buildings and other infrastructure, removing contaminated soil, protection of abandoned pits and re-vegetation.

At December 31, 2011, the Company recognized a decommissioning liability of $4.2 million (2010: $3.1 million). The fair value of the decommissioning liability is estimated using a present value method and is based on existing laws, contracts or other policies and current technology and conditions. The following significant assumptions were made for the purpose of estimating the decommissioning liability:

	As at December 31,	
($ in thousands)	**2011**	2010
Assumption		
Estimated future reclamation and closure costs	**$15,211**	$8,840
Discount rate	**10.5%**	8.0%
Average years to reclamation	**13**	14

10. Related party transactions

The Company had related party transactions with the following companies related by way of directors or shareholders in common:

- Ivanhoe is the Company's parent company and at December 31, 2011 owned approximately 58% of the outstanding common shares of the Company. Ivanhoe provides various administrative services to the Company on a cost-recovery basis. The Company also provides some office and investor relations services to Ivanhoe in the Company's Hong Kong office and recovers the costs for those and on a cost-recovery basis.
- Global Mining Management ("GMM") is a private Company owned equally by seven companies, two of which include the Company and Ivanhoe. GMM provides administration, accounting and other office services to the Company on a cost-recovery basis.
- I2MS.NET Pte. Ltd. ("I2MS") is a private company 100% owned by Ivanhoe. I2MS provides information technology and other related services to the Company on a cost-recovery basis.
- Ivanhoe Capital Aviation LLC ("Ivanhoe Aviation") is a private company 100% owned by Ivanhoe's Chief Executive Officer. Ivanhoe Aviation operates aircrafts which were rented by the Company on a cost-recovery basis for a portion of 2010 to facilitate the global equity offering. The contract with Ivanhoe Aviation was terminated in the fourth quarter of 2010 and the Company did not incur any costs in 2011.
- Ivanhoe Energy Inc. ("Ivanhoe Energy") is a publicly listed company with two directors in common with the Company. The Company provides some office and investor relations services to Ivanhoe Energy in the Company's Hong Kong office and recovers the costs for those services on a cost-recovery basis.

The following tables summarize related party expenses incurred by the Company with the companies listed above:

	Year ended December 31,	
($ in thousands)	**2011**	2010
Corporate administration	**$1,990**	$3,832
Salaries and benefits	**1,389**	2,120
Total related party expenses	**$3,379**	$5,952

	Year ended December 31,	
($ in thousands)	**2011**	2010
GMM	**$2,014**	$2,840
Ivanhoe	**94**	252
Ivanhoe Capital Aviation	**–**	1,725
I2MS	**1,271**	1,135
Total related party expenses	**$3,379**	$5,952

The Company also recorded recoveries of $0.5 million for year ended December 31, 2011 compared to $0.2 million for the year ended December 31, 2010 for administration expenses with Ivanhoe and Ivanhoe Energy.

The Company had accounts receivable of $0.3 million at December 31, 2011 (2010: $0.4 million) and accounts payable of $0.4 million at December 31, 2011 (2010: $0.9 million) with related parties.

10. Related party transactions continued

Emolument policy

The emolument policy of the executives of the Company is administered by the Compensation and Benefits Committee on the basis of merit, qualifications and competence and approved by the Board. The emolument policy for the rest of the employees is determined on a department by department basis with the executive in charge of each department determining the emoluments for senior employees and managers in the department and the emoluments for non-senior employees being determined by an appropriately designated manager. The emolument policy for non-executives is administered in conjunction with the human resources department and is done on the basis of merit, qualifications and competence.

The emolument policy for the directors of the Company is administered by the Compensation and Benefits Committee and approved by the Board, having regard to comparable market statistics.

The Company has also adopted a share option plan as incentive to directors and eligible employees. Details of the plan are set out in Note 22 of the Consolidated Financial Statements.

As at December 31, 2011, the Company employed 720 employees.

11. Outstanding share data

The Company is authorized to issue an unlimited number of common shares without par value and an unlimited number of preferred shares without par value. As at March 19, 2012, 181.9 million common shares were issued and outstanding. There are also incentive share options outstanding to acquire 10.8 million unissued common shares. There are no preferred shares outstanding.

As at March 19, 2012, Ivanhoe directly owned 104.8 million common shares representing approximately 58% of the issued and outstanding common shares of the Company.

12. Internal controls over financial reporting

Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with IFRS. Management is also responsible for the design of the Company's internal control over financial reporting in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS.

The Company's internal controls over financial reporting include policies and procedures that: pertain to the maintenance of records that, in reasonable detail accurately and fairly reflect the transactions and disposition of assets; provide reasonable assurance that transactions are recorded as necessary to permit preparation of the financial statements in accordance with IFRS and that receipts and expenditures are being made only in accordance with authorization of management and directors of the Company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the financial statements.

Because of their inherent limitations, internal controls over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Furthermore, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

12. Internal controls over financial reporting continued

The Company's management, under the supervision of the Chief Executive Officer and the Chief Financial Officer, has evaluated the effectiveness of the Company's internal controls over financial reporting using the framework and criteria established in *Internal Control-Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the evaluation, management has concluded that internal controls over financial reporting were effective as at December 31, 2011.

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

13. Critical accounting estimates and judgments

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

A detailed summary of all of the Company's significant accounting policies is included in Note 3 to the annual Consolidated Financial Statements for the year ended December 31, 2011.

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

Mineral properties

On the commencement of commercial production, depletion of each mineral property is recorded on a unit-of-production basis using economically recoverable reserves as the depletion base.

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 operating equipment and infrastructure is completed
- operating results are being achieved in a consistent manner

However, the commercial 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.

Decommissioning, restoration and similar liabilities

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

13. Critical accounting estimates and judgments continued

Inventories

Coal inventories are measured at the lower of production cost and net realizable value. Production cost is determined by the weighted average method and includes direct and indirect labor, operating materials and supplies, processing costs, transportation costs and an appropriate portion of fixed and variable overhead expenses. Fixed and variable overhead expenses include depreciation and depletion. Net realizable value represents the future estimated selling price of the product, less estimated costs of completion and costs necessary to bring the product to sale.

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

Stripping costs

Stripping costs incurred during the development phase of a mine are added to property, plant and equipment as mineral property costs. Stripping costs incurred during the commercial production phase are variable production costs that are included in the costs of inventory produced during the period incurred, unless the stripping activity can be shown to give rise to future benefits from the mineral property, in which case the stripping costs are added to the cost of mineral properties.

Future benefits arise when the 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.

Income taxes

Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are substantively enacted at the end of each reporting period.

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, associates and joint ventures, where the timing of the reversal of the temporary differences can be controlled by the parent, investor or venturer and it is probable that the temporary differences will not reverse in the foreseeable future.

13. Critical accounting estimates and judgments continued

Income taxes continued

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

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

The carrying amount of deferred income tax assets is reviewed at 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 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 profit or loss.

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.

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 payments, 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 the fair value of the share-based payment. Otherwise, share-based payments are measured at the fair value of goods or services received.

13. Critical accounting estimates and judgments continued

Share-based payments continued

Equity-settled transactions

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

The costs of equity-settled transactions are recognized, together with a corresponding increase in the share option reserve, over the period in which the performance and/or service conditions are fulfilled and end on the date on which the relevant employees become fully entitled to the award. The cumulative expense recognized for equity-settled transactions at each reporting date reflects the Company's best estimate of the number of equity instruments that will ultimately vest. No expense is recognized for awards that do not ultimately vest.

When 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 the modification.

Property, plant and equipment ("PPE")

PPE includes the Company's operating equipment and infrastructure, construction in progress and mineral properties. PPE is stated at cost less accumulated depreciation and depletion and accumulated impairment losses.

The cost of an item of operating equipment and infrastructure consists of the purchase price or construction cost, any costs directly attributable to bringing the asset to the location and condition necessary for its intended use, an initial estimate of the decommissioning liability and capitalized borrowing costs.

Construction in progress is classified to the appropriate category of PPE when it is completed and is ready for its intended use.

All direct costs related to the acquisition of mineral property interests are capitalized on a property by property basis. The cost of mineral properties includes deferred stripping costs and decommissioning liabilities related to the reclamation of the Company's mineral properties.

Depreciation is recorded based on the cost of an item of PPE, less its estimated residual value, using the straight-line method or unit-of-production method over the following estimated useful lives:

- Mobile equipment — 5 to 7 years
- Other operating equipment — 1 to 10 years
- Buildings and roads — 5 to 15 years
- Construction in progress — not depreciated
- Mineral properties — unit-of-production basis based on economically recoverable reserves

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 profit or loss.

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.

13. Critical accounting estimates and judgments continued

Valuation of embedded derivatives

The embedded derivatives in the CIC convertible debenture are valued 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. Dollar) and spot foreign exchange rates.

Recoverability of trade and other receivables

If there is objective evidence that an impairment loss on assets carried at amortized cost (i.e. trade and other receivables) 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.

Impairment testing

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 (or 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 periods.

14. Risk factors

There are certain risks involved in the Company's operations, some of which are beyond its control. These risks can be broadly categorized into: (i) risks relating to its business and industry; and (ii) risks relating to its projects in Mongolia. Additional risks and uncertainties not presently known, or not expressed or implied below, or that are presently deemed immaterial, could also harm the Company's business, financial condition and operating results. Some of the following statements are forward-looking and actual results may differ materially from the results anticipated in these forward-looking statements.

Risks relating to the Company's business and industry

Some of the Company's projects may not be completed as planned; costs may exceed original budgets and may not achieve the intended economic results or commercial viability.

The Company's business strategy depends in large part on expanding its production capacity at the Ovoot Tolgoi Mine and further developing its other coal projects into commercially viable mines. Whether a mineral deposit will be commercially viable depends on a number of factors, including: (i) the particular attributes of the deposit, such as size, grade and proximity to infrastructure; (ii) commodity prices, which are highly cyclical; and (iii) government regulations, including regulations relating to prices, taxes, royalties, land tenure, land use, importing and exporting of mineral resources and environmental protection. The Company's current intention to develop mines at the Soumber Deposit, the Zag Suuj Deposit, and the Ovoot Tolgoi Underground Deposit in the future is based on geological, engineering, environmental and mine planning evaluations. The feasibility of mining at these projects as well as at the Tsagaan Tolgoi Deposit has not been and may never be established. If the Company is unable to develop all or any of its projects into a commercial working mine, its business, financial condition and results of operations will be materially and adversely affected.

The Company's projects are subject to technical risk in that they may not perform as designed. Increased development costs, lower output or higher operating costs may all combine to make a project less profitable than expected at the time of the development decision. This would have a negative impact on the Company's business and results of operations. No assurance can be given that the Company would be adequately compensated by third party project design and construction companies (if not performed by the Company) in the event that a project did not meet its expected design specification.

The pre-feasibility study for the Ovoot Tolgoi Mine assumes that the Ejin Jinda wet wash plant at Ceke processes 1.5 million tonnes of coal in 2012. Commissioning of the wet wash plant is expected to be completed early in the second quarter of 2012. The pre-feasibility study also assumes that the Ejin Jinda wet wash plant is expanded to process 7.0 million tonnes annually from mid-2014. SouthGobi still needs to negotiate contracts for this expansion. Any delays in either commissioning the Ejin Jinda wet wash plant early in the second quarter of 2012 or expanding annual capacity to 7.0 million tonnes by mid-2014, would likely impact the project economics, as the coal would either be stockpiled or sold as lower value coal; however, these delays would be unlikely to impact on total reserve estimates.

As with all exploration properties or projects taken on by mining companies, there is a risk that exploration projects will not be converted to commercially viable mines, in part because actual costs from capital projects may exceed the original budgets. As a result of project delays, cost overruns, changes in market circumstances or other reasons, the Company may not be able to achieve the intended economic benefits or demonstrate the commercial feasibility of these projects, which in turn may materially and adversely affect the Company's business, results of operations and growth projects.

14. Risk factors continued

Risks relating to the Company's business and industry continued

The Company's coal reserves and resources are estimates based on a number of assumptions, and the Company may produce less coal than its current estimates.

The coal reserve and resource estimates are based on a number of assumptions that have been made by the Qualified Persons in accordance with NI 43-101. Reserve and resource estimates involve expressions of judgment based on various factors such as knowledge, experience and industry practice, and the accuracy of these estimates may be affected by many factors, including quality of the results of exploration drilling and analysis of coal samples, as well as the procedures adopted by and the experience of the person making the estimates.

The pre-feasibility study for the Ovoot Tolgoi Mine assumes that the SouthGobi mining lease will extend across its lease boundary and into the lease held by MAK. A memorandum of understanding covering mining across the lease boundary was signed in May 2007; however, an operational agreement is still being negotiated. If the operational agreement is delayed beyond mid–2012, the delay would likely impact the project economics. The resource and reserve estimates in this report do not include any coal within the MAK lease; however, the geological models and mining pits extend into the MAK lease. If an operational agreement cannot be finalized, then the reserve estimate could be materially affected.

Estimates of the reserves and resources at the Company's projects may change significantly when new information becomes available or new factors arise, and interpretations and deductions on which reserves and resources estimates are based may prove to be inaccurate. Should the Company encounter mineralization different from that predicted by past drilling, sampling and similar examination, mineral resource and/or reserve estimates may have to be adjusted downward. This downward adjustment could materially affect the Company's development and mining plans, which could materially and adversely affect its business and results of operations.

In addition, the rank of coal ultimately mined may differ from that indicated by drilling results. There can be no assurance that coal recovered in laboratory tests will be duplicated under on-site conditions or in production-scale operations. In the event that the actual level of impurities is higher than expected or the coal mined is of a lower quality than expected, the demand for, and realizable price of, the Company's coal may decrease. Short term factors relating to reserves, such as the need for orderly development of coal seams or the processing of new or different quality coals, may also materially and adversely affect the Company's business and results of operations.

The inclusion of reserve and resource estimates should not be regarded as a representation that all these amounts can be economically exploited and nothing contained herein (including, without limitation, the estimates of mine lives) should be interpreted as assurance of the economic lives of the Company's coal reserves and resources or the profitability of its future operations.

The Company commenced mining in April 2008, and has recorded operating losses and operating cash outflows to date, and therefore the Company's short operating history may make it difficult for investors to evaluate its business and growth.

In addition, the Company currently operates one revenue producing mine. As is typical for a start up mining company, the Company has recorded a deficit since inception. Although the Company has no plans to pay dividends in the near future, should such deficits continue and cash reserve be depleted, it could adversely affect the Company's ability to pay dividends in the future. Due to the Company's limited operating history, there may not be an adequate basis on which to evaluate the Company's future operating results and prospects. Investors may have difficulties evaluating the Company's business and prospects because the Company's past results may not be indicative of the Company's results in the future.

14. Risk factors continued

Risks relating to the Company's business and industry continued

The Company does not insure against all risks to which it may be subject in planned operations and insurance coverage could prove inadequate to satisfy potential claims.

For certain aspects of the Company's business operations, insurance coverage, in particular business interruption insurance, is restricted or prohibitively expensive. The Company currently holds its primary insurance policies through international insurance providers to insure its properties. The Company has taken out insurance for risks including commercial general liability and aviation premises liability. The Company maintains mining property insurance for all of its mining assets wherever located, property insurance on its office premises and liability insurance for its Directors and officers. However, no assurance can be given that the Company will elect or be able to obtain such insurance coverage at economically reasonable premiums (or at all), or that any coverage it obtains will be adequate to cover the extent of any claims brought against it.

Exploration, development and production operations on mineral properties involve numerous risks, including environmental risks, such as unexpected or unusual geological operating conditions, rock bursts or slides, fires, floods, earthquakes or other environmental occurrences, and political and social instability. The Company does not maintain insurance against any environmental or political risks. Should any liabilities arise for which it is not insured or insurance coverage is inadequate to cover the entire liability, they could reduce or eliminate the Company's actual or prospective profitability, result in increasing costs and a decline in the value of the common shares and could materially and adversely affect the Company's business and results of operations.

Licenses and permits are subject to renewal and various uncertainties and the Company may only renew its exploration licenses a limited number of times for a limited period of time.

In Mongolia, the Company's exploration licenses are subject to periodic renewal and may only be renewed a limited number of times for a limited period of time. While it anticipates that renewals will be given as and when sought, there is no assurance that such renewals will be given as a matter of course and there is no assurance that new conditions will not be imposed in connection therewith. The Company's business objectives may also be impeded by the costs of holding and/or renewing the exploration licenses in Mongolia. License fees for exploration licenses increase substantially upon the passage of time from the original issuance of each individual exploration license. The Company needs to assess continually the mineral potential of each exploration license, particularly at the time of renewal, to determine if the costs of maintaining the exploration licenses are justified by the exploration results to date, and may elect to let some of its exploration licenses lapse. A moratorium on transfers of exploration licenses has been imposed on two separate occasions and there is a risk that a similar moratorium could be imposed such that letting the exploration licenses lapse may be the only practical option in some circumstances. Furthermore, the Company will require mining licenses and permits to mine in order to conduct mining operations in Mongolia. There can be no assurance; however, that such licenses and permits will be obtained on terms favorable to it or at all for the Company's future intended mining and/or exploration targets in Mongolia.

In addition, certain provisions of the Land Law of Mongolia enacted on June 7, 2002, and effective from January 1, 2003, (the "Land Law") and the 2006 Minerals Law provide for the revocation of previously granted land use rights, exploration licenses or mining licenses on the grounds that the affected area of land has been designated as "special needs" territory. The Land Law grants the discretion to declare an area of land for special needs purposes to local governing authorities and identifies various broad categories which qualify as special needs. The 2006 Minerals Law requires the local governing authority that designates an area of land as a special needs territory to compensate the license holder whose rights or license status are affected. If any of the Company's land use rights, exploration licenses or mining licenses in Mongolia are revoked because the underlying land is declared as special needs territory, there is no assurance that the Company will receive adequate compensation or any compensation at all and its business and results of operation might be adversely and materially affected. The Company has had no land use rights or exploration/mining licenses revoked to date.

14. Risk factors continued

Risks relating to the Company's business and industry continued

Prolonged periods of severe weather conditions could materially and adversely affect the Company's business and results of operations.

Severe weather conditions may require the Company to evacuate personnel or curtail operations and may cause damages to the project site, equipment or facilities, which could result in the temporary suspension of operations or generally reduce the Company's productivity. Severe weather conditions have not caused any delay or damages to the Company's operations to date. However, there can be no assurance that severe weather will not occur. Any damages to the Company's projects or delays in its operations caused by prolonged periods of severe weather could materially and adversely affect its business and results of operations.

The Company's business and results of operations are susceptible to the cyclical nature of coal markets and are vulnerable to fluctuations in prices for coal.

The Company expects to derive substantially all of its revenue and cash flow from the sale of coal. Therefore, the market price of the shares, the Company's ability to raise additional financing and maintain ongoing operations and its financial condition and results of operations will be directly related to the demand for, and price of, coal and coal-related products. Coal demand and price are determined by numerous factors beyond the Company's control, including the international demand for steel and steel products, the availability of competitive coal supplies, international exchange rates, political and economic conditions in Mongolia, the People's Republic of China ("PRC") and elsewhere in the world, milder or more severe than normal weather conditions, and production costs in major coal producing regions. The PRC and international coal markets are cyclical and have in the past exhibited significant fluctuations in supply, demand and prices from year to year. There has been significant price volatility on the coal spot market. An oversupply of coal in the PRC or a general downturn in the economies of any significant markets for the Company's coal and coal-related products could materially and adversely affect its business and results of operations. In addition, the Company's dependence on Asian markets may result in instability in its operations due to political and economic factors in those Asian jurisdictions which are beyond the Company's control. The combined effects of any or all of these factors on coal prices or volumes are impossible for the Company to predict. If realized coal prices fall below the full cost of production of any of its future mining operations and remain at such a level for any sustained period, the Company could experience losses and may decide to discontinue operations, which could require the Company to incur closure costs and result in reduced revenues.

The Company's coal mining activities are subject to operational risks, including equipment breakdown.

The Company's coal mining operations are subject to a number of operational risks, some of which are beyond its control, which could delay the production and delivery of coal. These risks include unexpected maintenance or technical problems, periodic interruptions to its mining operations due to inclement or hazardous weather conditions and natural disasters, industrial accidents, power or fuel supply interruptions and critical equipment failure, including malfunction and breakdown of its shovels, upon which its coal mining operations are heavily reliant and which would require considerable time to replace. These risks and hazards may result in personal injury, damage to, or destruction of, properties or production facilities, environmental damage, business interruption and damage to its business reputation. In addition, breakdowns of equipment, difficulties or delays in obtaining replacement shovels and other equipment, natural disasters, industrial accidents or other causes could temporarily disrupt the Company's operations, which in turn may also materially and adversely affect its business, prospects, financial condition and results of operations.

14. Risk factors continued

Risks relating to the Company's business and industry continued

The unavailability or shortage of reliable and sufficient coal transportation capacity will reduce the Company's coal revenue by causing it to reduce its production volume or impairing its ability to supply coal to its customers.

The Company anticipates that the majority of its coal production from the projects in Mongolia will be exported into the PRC. Inadequate transportation infrastructure is likely to affect the pricing terms on which it can sell the coal to customers and the willingness and ability of such customers to purchase coal from it. Potential customers are likely to factor in any delays and the costs and availability of transportation in determining the price they are prepared to pay to purchase the Company's coal. Therefore, its mining operations are anticipated to be highly dependent on road and rail services in Mongolia and the PRC.

In Mongolia, a bottleneck in the transportation of coal from the Ovoot Tolgoi Mine to customers in the PRC may arise if the road connecting the Ovoot Tolgoi Mine to the Shivee Khuren Border Crossing does not have sufficient capacity to support the increased amount of cargo traffic or is affected by external factors such as disruptions caused by bad weather. The opening hours of the Shivee Khuren Border Crossing also affect the Company's ability to expedite the movement of its coal shipments. There can be no assurance that there would be any other cost effective means of transporting the coal to the Company's primary market in the PRC. As a result, the Company may experience difficulty expediting the movement of its coal shipments and/or significant cost escalation for the transportation services, which could affect its production and reduce its profitability.

In the PRC, rail and road infrastructure and capacity has in the past been affected by extreme weather conditions, earthquakes, delays caused by major rail accidents, the diversion of rolling stock needed to deliver emergency food relief and seasonal congestion during public holidays. There can be no assurance that these problems will not recur or that new problems will not occur. In any of these circumstances, the customers may not be able to take delivery of the Company's coal, which may lead to delays in payment, or refusal to pay, for the Company's coal and, as a result, the Company's business and results of operations could be materially and adversely affected.

The Company's prospects depend on its ability to attract, retain and train key personnel.

Recruiting, retaining and training qualified personnel is critical to the Company's success. The number of persons skilled in the acquisition, exploration and development of mining properties is limited and competition within the mining industry for such persons is intense, in particular, Mongolian law requires that at least 90% of a mining company's employees be of Mongolian nationality. This provision of the law, coupled with the large number of active mining projects in Mongolia, further limits the number of available personnel and increases competition for skilled personnel. As the Company's business activity grows, it will require additional key financial, administrative, mining, marketing and public relations personnel as well as additional operations staff. If the Company is not successful in attracting such key personnel, or retaining existing key personnel, its business and results of operations could be materially and adversely affected.

In addition, the Company's ability, to train operating and maintenance personnel is a key factor for the success of its business activities, if the Company is not successful in recruiting, training and retaining such personnel, its business and results of operations could be materially and adversely affected.

14. Risk factors continued

Risks relating to the Company's business and industry continued

Competition in the coal industry may hinder development plans and adversely affect the Company's coal sales if it is not able to compete effectively.

Continued growth in mining and mineral exploration activities in Mongolia could create an increasing demand for mining equipment and related services. Shortages of, or higher costs for, equipment and services could restrict the Company's ability to carry out the exploration, development and production activities, increase its costs of operations and adversely affect its future plans.

The Company intends to sell a majority of the coal it produces in the PRC. Competition in the PRC coal industry is based on many factors, including, among others, price, production capacity, coal quality and characteristics, transportation capability and costs, blending capability and brand name. The Company's coal business will most likely compete in the PRC with other large PRC and international coal mining companies. Due to their location, some of the Company's PRC competitors may have lower transportation costs than the Company does. The PRC coal market is highly fragmented and the Company faces price competition from some small local coal producers that produce coal for significantly lower costs than the Company due to various factors, including their lower expenditure on safety and regulatory compliance. Some of the Company's international competitors, including the Mongolian coal producers, may have greater coal production capacity as well as greater financial, marketing, distribution and other resources than the Company does, and may benefit from more established brand names in international markets. The Company's future success will depend on its ability to respond in an effective and timely manner to competitive pressure.

There are a number of risks associated with dependence on a limited number of customers and inability to attract additional customers.

The Company depends on a relatively small number of customers. The incremental cost of transporting coal products from the Ovoot Tolgoi Mine and its other coal projects over long distances effectively limits the Company's potential customer base to a relatively proximate geographical area. Additionally, the Company has been selling its coal products only since September 2008. The Company currently has eight active customers with the largest customer representing approximately 46%, the second largest customer representing approximately 22% and the remaining customers accounting for 32% of the Company's total sales for the year ended December 31, 2011. The Company's relatively brief history of coal sales makes it difficult to evaluate the strength of its relationships with current customers and its ability to attract additional customers. Accordingly, the inability to attract additional customers or the loss of, or a significant reduction in, purchases by any of the limited number of potential customers could materially and adversely affect the Company's future revenue and the economic viability of its exploration and development projects. In order to mitigate this risk, the Company is continually expanding its customer base. As at March 19, 2012, the Company had signed sales contracts with four customers for coal sales in 2012 and is in discussions with several other potential customers.

In addition, the Company expects to sell the majority of the coal from its Mongolian mining operations to the customers in the PRC. PRC law requires specific authorization to be obtained by entities responsible for the import of coal into the PRC. In the event that the Company's customers, or the agents of such customers who are responsible for importing coal into the PRC on their behalf, fail to obtain and retain the necessary authorizations, their ability to import coal into the PRC may be affected, which could materially and adversely affect the Company's business and results of operations.

14. Risk factors continued

Risks relating to the Company's business and industry continued

The Company's operations are exposed to risks in relation to environmental protection and rehabilitation.

The operations of coal mines involve substantial environmental risks and hazards and the Company's operations are subject to laws and regulations relating to the environment, health and safety and other regulatory matters in Mongolia.

The risk of environmental liability is inherent in the operation of the Company's business. Environmental hazards may occur in connection with the Company's operations as a result of human negligence, force majeure, or otherwise. Claims may be asserted against the Company arising out of its operations in the normal course of business, including claims relating to land use, safety, health and environmental matters. The Company is not insured against environmental liabilities and there can be no assurance that environmental liabilities would not materially and adversely affect its business and results of operations.

In addition, the Company is subject to reclamation requirements. The Company's mines contain a finite amount of reserves and will eventually close. The key tasks in relation to the closure of the mines involve (i) long-term management of permanent engineered structures (for example, spillways, roads, waste dumps); (ii) achievement of environmental closure standards; (iii) orderly retrenchment of employees and contractors; and (iv) relinquishment of the site with associated permanent structures and community development infrastructure and programs to new owners. The successful completion of these tasks is dependent on the Company's ability to successfully implement negotiated agreements with the relevant government, community and employees. The consequences of a difficult closure range from increased closure costs and handover delays to ongoing environmental impacts and corporate reputation damage if desired outcomes cannot be achieved, which could materially and adversely affect the Company's business and results of operations.

Environmental legislation is evolving in a manner which will require stricter standards and enforcement, increased fines and penalties for non-compliance, more stringent environmental assessments of proposed projects and a heightened degree of responsibility for companies and their officers, directors and employees. The Company may experience increased costs of production arising from compliance with environmental laws and regulations. Should the Company fail to comply with current or future environmental laws and regulations, the Company may be required to pay penalties or take corrective actions, any of which may have a material adverse effect on its results of operations and financial condition.

Foreign currency fluctuations could affect expenses and any future earnings.

The Company is exposed to foreign exchange fluctuations with respect to the Mongolian Tugrik, Chinese Renminbi, Hong Kong, Australian and Canadian dollars. The Company's financial results are reported in U.S. Dollars. The salaries for local laborers in Mongolia are paid in local currency. Sales of coal into the PRC have been and may continue to be settled in U.S. dollars and Renminbi. The Company has a subsidiary in Hong Kong where some expenses are incurred in Hong Kong dollars. The Company has long term investments denominated in Australian dollars. Since the Company's headquarters is in Canada, a minor portion of its expenses are in Canadian dollars and the Company holds a portion of its cash in Canadian dollars. As a result, its financial position and results are impacted by the exchange rate fluctuations between the aforementioned currencies and the U.S. Dollar.

14. Risk factors continued

Risks relating to the Company's business and industry continued

The Company's results of operations are subject, to a significant extent, to economic, political and legal developments in the PRC.

The Company expects that a majority of coal sales from the Ovoot Tolgoi Mine will be made to customers based in the PRC. Accordingly, the economic, political and social conditions, as well as government policies, of the PRC may affect its business. The PRC economy differs from the economies of most developed countries in many respects, including: (i) structure; (ii) level of government involvement; (iii) level of development; (iv) growth rate; (v) control of foreign exchange; and (vi) allocation of resources. The PRC economy has been transitioning from a planned economy to a more market-oriented economy. For the past two decades, the PRC government has implemented economic reform measures emphasizing the utilization of market forces in the development of the PRC economy. Changes in the PRC's political, economic and social conditions, laws, regulations and policies could materially and adversely affect the Company's business and results of operations.

In addition, the PRC government indirectly influences coal prices through its regulation of power tariffs and its control over allocation of the transportation capacity of the national rail system. Any significant downturn in the prices in the PRC could materially and adversely affect the Company's business and results of operations. Additionally, the PRC government could adopt new policies that could shift demand away from coal to other energy sources. Any significant decline in demand for, or over-supply of, coal could materially and adversely affect the Company's revenues from coal export sales.

The interests of the Company's principal shareholder, Ivanhoe, may differ from those of its other shareholders.

As of March 19, 2012, Ivanhoe holds approximately 58% of the Company's issued and outstanding common shares. The interests of Ivanhoe may conflict with the interests of the Company's other shareholders and there is no assurance that Ivanhoe will vote its common shares in a way that benefits the Company's minority shareholders. Subject to CIC's right to appoint a director, Ivanhoe's ownership interest enables Ivanhoe to elect the entire Board without the concurrence of any of the Company's other shareholders. Accordingly, unless applicable laws or regulations would require approval by the Company's minority shareholders, Ivanhoe is in a position to: (i) control the Company's policies, management and affairs; (ii) subject to applicable laws, regulations and the articles, adopt amendments to certain provisions of the Articles; and (iii) otherwise determine the outcome of most corporate actions, including a change in control, merger or sale of all or substantially all of the Company's assets.

The Company believes that third parties may be discouraged from making a tender offer or bid to acquire the Company because of this concentration of ownership.

Information in this document regarding future plans reflects current intentions and is subject to change.

Whether the Company ultimately implements the business strategies described in this document will depend on a number of factors including, but not limited to: the availability and cost of capital; current and projected coal prices; coal markets; costs and availability of drilling services, costs and availability of heavy equipment, supplies and personnel; success or failure of activities in similar areas to those in which the Company's projects are situated; and changes in estimates of project completion costs. The Company will continue to gather information about its projects, and it is possible that additional information will cause it to alter its schedule or determine that a project should not be pursued at all. Accordingly, the Company's plans and objectives may change from those described in this document.

14. Risk factors continued

Risks relating to the Company's business and industry continued

Future stock market conditions may change.

There are risks involved with any equity investment. The market price of common shares may rise or fall depending upon a range of factors and stock market conditions, which are unrelated to the Company's future financial performance. Movements on international stock markets, local interest rates and exchange rates, domestic and international economic and political conditions, as well as government, taxation and other policy changes may affect the stock market. As the Company is a listed company on the TSX and the HKEX, its common share price will also be subject to numerous influences including broad trends in the stock market and the share prices of individual companies or sectors.

Future issuances or sales, or perceived possible issuances or sales, of substantial amounts of common shares in the public market could materially and adversely affect the prevailing market price of the common shares and the Company's ability to raise capital in the future.

The market price of the common shares could decline as a result of future sales of substantial amounts of the common shares or other securities relating to the common shares in the public market, including sales by its substantial shareholders, or the issuance of new common shares by the Company, or the perception that such sales or issuances may occur. Future sales, or perceived possible sales, of substantial amounts of the common shares could also materially and adversely affect the Company's ability to raise capital in the future at a time and at a price favorable to it, and the Company's shareholders may experience dilution in their holdings upon issuance or sale of additional common shares or other securities in the future.

Risks relating to the company's projects in Mongolia

Legislation in Mongolia may be subject to conflicting interpretations, which may have adverse consequences on the Company's business.

The Mongolian legal system shares several of the qualitative characteristics typically found in a developing country and many of its laws, particularly with respect to matters of taxation, are still evolving. A transaction or business structure that would likely be regarded under a more established legal system as appropriate and relatively straightforward might be regarded in Mongolia as outside the scope of existing Mongolian law, regulation or legal precedent. As a result, certain business arrangements or structures and certain tax planning mechanisms may carry significant risks. In particular, when business objectives and practicalities dictate the use of arrangements and structures that, while not necessarily contrary to settled Mongolian law, are sufficiently novel within a Mongolian legal context, it is possible that such arrangements may be invalidated.

The legal system in Mongolia has inherent uncertainties that could limit the legal protections available to the Company, which include: (i) inconsistencies between laws; (ii) limited judicial and administrative guidance on interpreting Mongolian legislation; (iii) substantial gaps in the regulatory structure due to delay or absence of implementing regulations; (iv) the lack of established interpretations of new principles of Mongolian legislation, particularly those relating to business, corporate and securities laws; (v) a lack of judicial independence from political, social and commercial forces; and (vi) bankruptcy procedures that are not well developed and are subject to abuse. The Mongolian judicial system has relatively little experience in enforcing the laws and regulations that currently exist, leading to a degree of uncertainty as to the outcome of any litigation; it may be difficult to obtain swift and equitable enforcement, or to obtain enforcement of a judgment by a court of another jurisdiction.

14. Risk factors continued

Risks relating to the company's projects in Mongolia continued

Legislation in Mongolia may be subject to conflicting interpretations, which may have adverse consequences on the Company's business. continued

In addition, while legislation has been enacted to protect private property against expropriation and nationalization, due to the lack of experience in enforcing these provisions and political factors, these protections may not be enforced in the event of an attempted expropriation or nationalization. Expropriation or nationalization of any of the Company's assets, or portions thereof, potentially without adequate compensation, could materially and adversely affect its business and results of operations.

Application of and amendments to legislation could adversely affect the Company's mining rights in its projects or make it more difficult or expensive to develop its projects and carry out mining.

The 2006 Minerals Law, which preserves to a limited extent some of the substance of the former 1997 minerals legislation, was drafted with the assistance of legal experts in the area of mining legislation and was widely regarded as progressive, internally consistent and effective legislation. However, the 2006 Minerals Law contains new provisions that have increased the potential for political interference and weakened the rights and security of title holders of mineral tenures in Mongolia. Certain provisions of the 2006 Minerals Law are ambiguous and it is unclear how they will be interpreted and applied in practice. Examples of such provisions include those relating to the designation of a mineral deposit as a Mineral Deposit of Strategic Importance. The Government of Mongolia could determine that any one or more of the Company's projects in Mongolia is a Mineral Deposit of Strategic Importance.

In addition, the introduction of new Mongolian laws and regulations and the interpretation of existing ones may be subject to policy changes reflecting domestic political or social changes. For example, on July 16, 2009, Parliament enacted the Mining Prohibition in Specified Areas Law that prohibits minerals exploration and mining in areas such as headwaters of rivers and lakes, forest areas as defined in the Forest Law of Mongolia and areas adjacent to rivers and lakes as defined in the Water Law of Mongolia. Pursuant to the Mining Prohibition in Specified Areas Law, the Government of Mongolia was instructed to define the boundaries of the areas in which exploration and mining would be prohibited by October 16, 2009. However, the Government of Mongolia has not yet approved and published this information. New exploration licenses and mining licenses overlapping the defined prohibited areas will not be granted, and previously granted licenses that overlap the defined prohibited areas will be terminated within five months following the adoption of the law. It is not clear whether such termination will only apply to the overlap areas. The Mining Prohibition in Specified Areas Law provides that affected license holders shall be compensated, but there are no specifics as to the way such compensation will be determined.

MRAM has prepared a draft list of licenses that overlap with the prohibited areas described in the new law, based on information submitted by water authority agencies, forest authority agencies and local authorities for submission to the Mongolian Ministry of Resources and Energy ("MMRE"). Subsequent to the MMRE's approval of this preliminary list, the Government of Mongolia must still give its final approval before the final list can be published. During the MMRE's and the Government of Mongolia's review of the draft list of licenses prepared by MRAM, licenses may be added or subtracted to the list at any time prior to approval and publication of the final list.

14. Risk factors continued

Risks Relating to the Company's Projects in Mongolia continued

Application of and amendments to legislation could adversely affect the Company's mining rights in its projects or make it more difficult or expensive to develop its projects and carry out mining. continued

The Company's Tsagaan Tolgoi mining license and exploration licenses pertaining to the Zag Suuj Deposit and the South Biluut and Jargalant Fields within the Soumber Deposit, as well as, two other exploration licenses may be included on the final list published by the Government of Mongolia, potentially affecting the status of those licenses under the Mining Prohibition in Specified Areas Law. Activities being carried out on these properties include drilling, trenching and geological reconnaissance. The Company has no immovable assets located in any of the potentially affected areas and the loss of any or all of the potentially affected properties would not materially and adversely affect its existing operations. However, the loss of the Tsagaan Tolgoi mining licenses and exploration licenses pertaining to the Zag Suuj Deposit and the South Biluut and Jargalant Fields within the Soumber Deposit would impact the Company's resources.

As such, there can be no assurance that future political and economic conditions in Mongolia will not result in the Government of Mongolia adopting different policies in relation to foreign development and ownership of mineral resources. Any such changes in government or policy may result in changes in laws affecting ownership of assets, environmental protection, labor relations, repatriation of income, return of capital, investment agreements, income tax laws, royalty regulation, government incentive and other areas, each of which may materially and adversely affect the Company's ability to undertake exploration and development activities in the manner currently contemplated. Similarly, any restrictions imposed, or Government of Mongolia charges levied or raised (including royalty fees), under Mongolian law for the export of coal could harm the Company's competitiveness.

The Company's ability to carry on business in Mongolia is subject to political risk.

The Company's ability to efficiently conduct its exploration and development activities is subject to changes in government policy or shifts in political attitudes within Mongolia that are beyond the Company's control.

Government policy may change to discourage foreign investment, nationalization of mining industries may occur or other government limitations, restrictions or requirements not currently foreseen may be implemented. There is no assurance that the Company's assets will not be subject to nationalization, requisition or confiscation, whether legitimate or not, by any authority or body. The provisions under Mongolian law for compensation and reimbursement of losses to investors under such circumstances may not be effective to restore the value of the Company's original investment.

In addition, Mongolia may experience political instability. Such instability could have a material adverse effect on economic or social conditions in Mongolia and may result in outbreaks of civil unrest, terrorist attacks or threats or acts of war in the affected areas, any of which could materially and adversely affect the Company's business and results of operations.

14. Risk factors continued

Risks Relating to the Company's Projects in Mongolia continued

The Government of Mongolia could determine that any one or more of the Company's projects in Mongolia is a Mineral Deposit of Strategic Importance.

Pursuant to the 2006 Minerals Law, the Parliament of Mongolia has wide discretion to designate mineral deposits to be Mineral Deposits of Strategic Importance. The Government of Mongolia is empowered to participate on an equity basis with the license holder in the exploitation and/or mining of each Mineral Deposit of Strategic Importance on terms to be negotiated between the Government of Mongolia and such license holder. Details of any minerals reserves must be filed by the relevant license holder with the Government of Mongolia, and those deposits on the Strategic Deposits List represent most of the largest and highest profile deposits in Mongolia. In addition to deposits currently on the Strategic Deposits List and the additional Tier 2 Deposits List, the Mongolian Parliament may at any time designate other deposits not yet currently on such Lists to be Mineral Deposits of Strategic importance, add such deposits to either the Strategic Deposits List or the Tier 2 Deposits List and, in the former case, commence negotiations with the relevant license holder with respect to the terms under which the Government of Mongolia will take an interest in such deposit. While the Government of Mongolia is in the process of adding the exact location and coordinates for each Mineral Deposit of Strategic Importance, a number of deposits on the Strategic Deposits List are identified by name only with no indication of the latitude and longitude coordinates for the deposit, and it is therefore not always possible to precisely determine the intended geographic area covered by each designated Mineral Deposit of Strategic Importance or to accurately determine whether or not any given license area is within, or overlaps, a Mineral Deposit of Strategic Importance.

Under the 2006 Minerals Law, the size of the Government of Mongolia's participation is determined largely by the level of state funding which has been provided for the exploration and development of any deposit, with the Government of Mongolia entitled to participate up to 50% in the event that there has been state funding of such deposit and up to 34% if there has not. However the 2006 Minerals Law is very vague as to the details and method by which the Government of Mongolia will take its interest and the final arrangements in respect of the Government of Mongolia's interest in each Mineral Deposit of Strategic importance, including the amount of compensation to be paid to the license holder and the actual form of the Government of Mongolia's interest are subject to negotiation between the Government of Mongolia and the license holder.

The 2006 Minerals Law also contains provisions requiring any company which holds a Mineral Deposit of Strategic Importance to list no less than 10% of its shares on the Mongolian Stock Exchange. This particular provision of the 2006 Minerals Law has not yet been enforced and it is not clear how it will work in practice.

In recent years there have been a number of proposed amendments to the 2006 Minerals Law suggested by various parties, many of which have centered on amending the 2006 Minerals Law to increase the Government of Mongolia's participating interest in excess of 50%. While the 2006 Minerals Law provides that the interest of the Government of Mongolia should take the form of an equity interest, based on past practice, and depending on the results of individual negotiations, the interest may be in the form of production or profit sharing or some other arrangement negotiated between the license holder and the Government of Mongolia. There can be no assurance that legislation will not be enacted which further strengthens the Government of Mongolia's right to participate in privately held mineral resources in Mongolia.

None of the deposits covered by the Company's existing mining licenses or exploration licenses are currently designated as Mineral Deposits of Strategic Importance. However, there can be no assurance that any one or more of these deposits will not be so designated in the future, in which case the Company's business and results of operations may be materially and adversely affected.

15. Outlook

During 2011 SouthGobi succeeded in growing and improving the value of its coal. Average gross selling price increased by $19.42 per tonne (56%) to $54.03 per tonne, whilst total cash costs only increased by $3.31 per tonne to $24.01 per tonne which was primarily due to the year over year increase in average fuel costs of approximately 55% per tonne of product sold and increased screening activities. Profitability generally improved during the course of the year and the final quarter of 2011 saw a record spread of $32.42 between the average selling price per tonne and total cash cost per tonne.

Much has been said by publicly-listed coking coal producers regarding weaker current market conditions. North American and Australian coking coal producers have mostly indicated that early 2012 will be characterized by lower prices and lower physical demand in the seaborne coking coal arena. However, SouthGobi believes its location in Southern Mongolia and closer nexus with the China market provides it with a different market environment. China is absolutely the key theme for internationally traded coking coal. From 2008 to 2011 China grew its annual net coking coal imports by approximately 38.0[1] million tonnes, whilst the rest of the world combined actually reduced net coking coal imports by approximately 10.0[2] million tonnes. Mongolia, being a direct neighbor to China and with scalable land-based infrastructure, has now become the dominant supplier of China's coking coal import requirements. Mongolia provided approximately 45%[1] of China's coking coal import needs in 2011, almost twice the share of the next largest supplier, Australia.

China continues to grow its requirements for coking coal and the Chinese market environment is more stable than the relatively smaller seaborne market. Since peaking at the start of 2011, seaborne coking coal prices have fallen by up to 44%[2] whereas Chinese regional domestic coking coal prices have generally risen in that period.

The first quarter of any year is generally the worst for border throughput capacity owing to the extended closure of the Shivee Khuren Border Crossing for the Chinese New Year and Mongolian Tsagaan Sar public holidays. This generally impacts coal sales. For example, in 2011, first quarter sales represented only approximately 11% of the total amount of coal sold for the year. SouthGobi anticipates the border to be open 40-50% less time in the first quarter of 2012 than any typical second, third or fourth quarter. However, despite this, the Company has contracted to sell 50-60% more coal than in the first quarter of 2011, which if achieved will put it ahead of plan for year over year sales volume growth.

In terms of pricing, SouthGobi currently forecasts to set a new record level for its gross average sales price in the first quarter of 2012. Contract pricing for individual coal types has been set broadly constant with the fourth quarter of 2011 or moderately improved. The sales mix will improve due to the impact of the DCHF, which has substantially reduced the quantity of higher-ash coal being produced. Furthermore, the Company continues to stock-pile some higher-ash coal in anticipation of completing the commissioning of the Ejin Jinda wet washing facility.

The year ended December 31, 2011 was the most meaningful year of investment for SouthGobi. Absent any change in external conditions, the Company anticipates its rate of investment to slow in 2012 and its income from mining operations to increase materially. At the end of 2011, SouthGobi's combined cash and cash equivalents and money market investments were approximately $168.6 million. At this stage, the Company believes these resources combined with anticipated income from its mining operations will be sufficient to execute its strategy.

Notes:

1 China Coal Resource (en.sxcoal.com)

2 AME Group: Strategic Market Study – Metallurgical Coal 2011 Q4

15. Outlook continued

SouthGobi is uniquely positioned, with a number of key competitive strengths, including:

- Strategic location – SouthGobi is the closest major coking coal producer in the world to China. Our Ovoot Tolgoi Mine is approximately 40 kilometers from China, which is approximately 190km closer than Tavan Tolgoi coal producers in Mongolia and 7,000 to 10,000km closer than Australian and North American coking coal producers. The Company has an infrastructure advantage, being approximately 50km from existing railway infrastructure, which is approximately one tenth the distance to rail of Tavan Tolgoi coal producers in Mongolia.
- Premium quality coals – Most of the Company's coal resources have coking properties, including a mixture of semi-soft coking coals and hard coking coals. SouthGobi is also completing its investment in processing infrastructure to capture more of the value by selling 'clean' instead of 'raw' coal products.
- Sustainable volume growth – SouthGobi's coal sales volume grew by approximately 58% from 2010 to 2011. 2012 will see continued growth at the Ovoot Tolgoi Mine. Currently undeveloped resources at the Soumber Deposit and the Zag Suuj Deposit will provide additional growth in the future.
- Expanding margins – 2011 gross profit per tonne of coal sold was more than three times the amount realized in 2010. The Company believes, subject to market conditions, it will continue expanding margins in the near term through the benefits of coal processing and increasing economies of scale.
- Exploration as a core business competency – SouthGobi's resources in Mongolia have been acquired through a long term in-house exploration program. The Company continues to maintain an active exploration program that provides additional resources of coal in a cost effective manner. The $31.8 million exploration program in 2011 added 32.0 million tonnes of measured coal resources, 97.0 million tonnes of indicated coal resources and 72.1 million tonnes of inferred coal resources.

Objectives

The Company's objectives for 2012 are as follows:

- **Grow Ovoot Tolgoi Mine** – The additional capacity of the new mining fleets should support growth in coal availability and sales for 2012 over 2011.
- **Continue to develop regional infrastructure** – The Company's immediate priority centers on improving roads in the area around the Ovoot Tolgoi Mine. SouthGobi is part of a consortium awarded the tender to construct a paved highway from the Ovoot Tolgoi Complex to the Shivee Khuren Border Crossing. The consortium intends to imminently commence construction of the highway that is expected upon completion to have a carrying capacity in excess of 20 million tonnes of coal per year.
- **Advancing the Soumber Deposit** – SouthGobi intends to further advance the feasibility, planning and preparation for a mine at Soumber.
- **Value-adding/upgrading coal** – Ejin Jinda is close to completing the commissioning of its wet washing facility to process some SouthGobi coals close to the Shivee Khuren Border Crossing on a toll washing arrangement.
- **Exploration** – Exploration will take place to further define the Company's existing deposits.
- **Operations** – Continuing to focus on production safety, environmental protection, operational excellence and community relations.

March 19, 2012

Consolidated financial statements

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Independent auditor's report

To the Shareholders of SouthGobi Resources Ltd.

We have audited the accompanying consolidated financial statements of SouthGobi Resources Ltd., which comprise the consolidated statements of financial position as at December 31, 2011 and December 31, 2010, and the consolidated statements of comprehensive income, changes in equity, and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of SouthGobi Resources Ltd. as at December 31, 2011 and December 31, 2010 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

Deloitte & Touche LLP

Chartered Accountants
March 19, 2012
Vancouver, Canada

Consolidated statement of comprehensive income

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

		Year ended December 31,	
	Notes	**2011**	2010
Revenue		**$179,049**	$79,777
Cost of sales	2.3, 5	**(127,343)**	(69,904)
Gross profit		**51,706**	9,873
Other operating expenses	2.3, 6	**(29,189)**	(12,643)
Administration expenses	2.3, 7	**(28,749)**	(25,438)
Evaluation and exploration expenses	8	**(31,768)**	(18,769)
Loss from operations		**(38,000)**	(46,977)
Finance costs	9	**(12,765)**	(175,855)
Finance income	9	**107,732**	103,948
Income/(loss) before tax		**56,967**	(118,884)
Current income tax expense	10	**(7,340)**	(1,806)
Deferred income tax recovery	10	**8,118**	4,495
Net income/(loss) attributable to equity holders of the Company		**57,745**	(116,195)
OTHER COMPREHENSIVE INCOME			
(Loss)/gain on available-for-sale assets, net of tax	13	**(11,202)**	27,761
Net comprehensive income/(loss) attributable to equity holders of the Company		**$46,543**	$(88,434)
BASIC INCOME/(LOSS) PER SHARE	11	**$0.32**	$(0.66)
DILUTED LOSS PER SHARE	11	**$(0.19)**	$(0.66)

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated statement of financial position

(expressed in thousands of U.S. Dollars)

	Notes	As at December 31, 2011	2010
ASSETS			
Current assets			
Cash and cash equivalents		**$123,567**	$492,038
Trade and other receivables	12	**80,285**	30,246
Short term investments	13	**–**	17,529
Inventories	14	**52,443**	26,160
Prepaid expenses and deposits	15	**38,308**	10,264
Total current assets		**294,603**	576,237
Non-current assets			
Prepaid expenses and deposits	15	**8,389**	–
Property, plant and equipment	16	**498,533**	266,771
Deferred income tax assets	10	**19,560**	11,442
Long term investments	13	**99,238**	107,416
Total non-current assets		**625,720**	385,629
Total assets		**$920,323**	$961,866
EQUITY AND LIABILITIES			
Current liabilities			
Trade and other payables	17	**$52,235**	$24,137
Current portion of convertible debenture	19	**6,301**	6,312
Total current liabilities		**58,536**	30,449
Non-current liabilities			
Convertible debenture	19	**139,085**	245,498
Deferred income tax liabilities	10	**2,366**	3,966
Decommissioning liability	20	**4,156**	3,063
Total non-current liabilities		**145,607**	252,527
Total liabilities		**204,143**	282,976
Equity			
Common shares	21	**1,054,298**	1,061,560
Share option reserve	23	**44,143**	32,360
Investment revaluation reserve	23	**16,559**	27,761
Accumulated deficit	24	**(398,820)**	(442,791)
Total equity		**716,180**	678,890
Total equity and liabilities		**$920,323**	$961,866
Net current assets		**$236,067**	$545,788
Total assets less current liabilities		**$861,787**	$931,417

Commitments for expenditure (Note 30), contingencies (Note 31) and subsequent event (Note 32)

The accompanying notes are an integral part of these consolidated financial statements.

APPROVED BY THE BOARD:

"André Deepwell"

Director

"Pierre Lebel"

Director

Consolidated statement of changes in equity

(expressed in thousands of U.S. Dollars and shares in thousands)

	Number of shares	Common shares	Share option reserve	Investment revaluation reserve	Accumulated deficit	Total
Balances, January 1, 2010	134,517	$296,419	$22,300	$–	$(321,511)	$(2,792)
Shares issued for:						
Cash	27,228	441,130	–	–	–	441,130
Share issue costs	–	(27,200)	–	–	–	(27,200)
Conversion of convertible debenture	21,471	347,643	–	–	–	347,643
Interest settlement on convertible debenture	90	1,436	–	–	–	1,436
Exercise of share options	1,090	7,434	(3,200)	–	–	4,234
Share-based compensation charged to operations	–	–	13,260	–	–	13,260
Common shares repurchased and cancelled	(911)	(5,272)	–	–	(5,085)	(10,357)
Share buy-back costs	–	(30)	–	–	–	(30)
Net loss for the year	–	–	–	–	(116,195)	(116,195)
Other comprehensive income for the year	–	–	–	27,761	–	27,761
Balances, December 31, 2010	183,485	$1,061,560	$32,360	$27,761	$(442,791)	$678,890
Shares issued for:						
Interest settlement on convertible debenture	**375**	**$4,011**	**$–**	**$–**	**$–**	**$4,011**
Exercise of share options	**760**	**8,006**	**(2,627)**	**–**	**–**	**5,379**
Share-based compensation charged to operations	**–**	**–**	**14,410**	**–**	**–**	**14,410**
Common shares repurchased and cancelled	**(3,300)**	**(19,167)**	**–**	**–**	**(13,774)**	**(32,941)**
Share buy-back costs	**–**	**(112)**	**–**	**–**	**–**	**(112)**
Net income for the year	**–**	**–**	**–**	**–**	**57,745**	**57,745**
Other comprehensive loss for the year	**–**	**–**	**–**	**(11,202)**	**–**	**(11,202)**
Balances, December 31, 2011	**181,320**	**$1,054,298**	**$44,143**	**$16,559**	**$(398,820)**	**$716,180**

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated statement of cash flows

(expressed in thousands of U.S. Dollars)

	Notes	Year ended December 31, 2011	2010
OPERATING ACTIVITIES			
Income/(loss) before tax		**$56,967**	$(118,884)
Adjustments for:			
Depreciation and depletion		**28,052**	13,219
Share-based compensation	23	**14,410**	13,260
Fair value gain on embedded derivatives in convertible debenture	19	**(106,489)**	(100,637)
Loss on partial conversion of convertible debenture		**–**	151,353
Mark to market adjustment on investments		**3,091**	(870)
Interest income		**(1,243)**	(2,441)
Interest expense		**9,488**	24,425
Interest paid		**(16,352)**	(21,926)
Income taxes paid		**(7,970)**	–
Unrealized foreign exchange gain		**(593)**	(3,703)
Loss on disposal of property, plant and equipment		**3,005**	3,770
Provision for doubtful trade and other receivables	12	**1,892**	–
Impairment of inventories	14	**2,396**	5,751
Impairment of property, plant and equipment	16	**16,605**	1,833
Other adjustments		**290**	77
Operating cash flows before changes in non-cash working capital items		**3,549**	(34,773)
Net change in non-cash working capital items	29	**(73,572)**	(23,075)
Cash used in operating activities		**(70,023)**	(57,848)
INVESTING ACTIVITIES			
Purchase of property, plant and equipment		**(282,967)**	(199,770)
Interest received		**1,356**	2,336
Proceeds from disposal of property, plant and equipment		**1,285**	22
Maturity of short and long term investments		**62,529**	45,000
Purchase of long term investments		**(52,635)**	(65,293)
Cash used in investing activities		**(270,432)**	(217,705)
FINANCING ACTIVITIES			
Proceeds from issuance of common shares and exercise of stock options, net of issue costs		**5,379**	422,729
Repurchase of common shares, including transaction costs		**(33,053)**	(10,387)
Drawings under line of credit facility		**131,500**	46,700
Repayments of line of credit facility		**(131,400)**	(49,700)
Cash (used in)/generated from financing activities		**$(27,574)**	$409,342
Effect of foreign exchange rate changes on cash		**(442)**	907
(Decrease)/increase in cash and cash equivalents		**(368,471)**	134,696
Cash and cash equivalents, beginning of year		**492,038**	357,342
Cash and cash equivalents, end of year		**$123,567**	$492,038
COMPRISED OF:			
Cash		**$123,567**	$461,853
Money market instruments		**–**	30,185
Total cash and cash equivalents		**$123,567**	$492,038

Supplemental cash flow information (Note 29)

The accompanying notes are an integral part of these consolidated financial statements.

Notes to the consolidated financial statements

December 31, 2011

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

1. Corporate information

SouthGobi 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. The company, together with its subsidiaries (collectively referred to as the "Company"), is an integrated coal mining, development and exploration company. The Company's parent is Ivanhoe Mines Ltd. (the "parent" or "Ivanhoe Mines") and at December 31, 2011, Ivanhoe Mines owned approximately 58% of the outstanding common shares of the Company.

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

The Company's financial statements and those of all of its controlled subsidiaries are presented in U.S. Dollars and all values are rounded to the nearest thousand Dollars except where otherwise indicated. Information related to shares and stock options is presented in thousands except for per share information, which is presented in U.S. Dollars.

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.

2. Basis of preparation

2.1 Statement of compliance

The Company's consolidated financial statements, including comparatives, 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 IFRS Interpretations Committee, effective for the Company's reporting for the year ended December 31, 2011.

2.2 Basis of presentation

The Company's consolidated financial statements have been prepared on the historical cost basis except for certain financial instruments. The Company's financial instruments are further disclosed in Note 26.

2.3 Prior period reclassifications

Certain items within the Company's consolidated statement of comprehensive income have been reclassified to better reflect the Company's increased mining operations in the year ended December 31, 2011.

The reclassifications have resulted in the introduction of a new line item entitled "other operating expenses". Expenses included in the other operating expenses line item include operating items such as: gains, losses and impairment charges on certain assets, public infrastructure expenses, sustainability and community relations expenses and foreign exchange amounts.

For the year ended December 31, 2010, the reclassifications resulted in $7,584 from cost of sales and $5,059 from administration expenses being reclassified to other operating expenses.

2. Basis of preparation continued

2.4 Adoption of new and revised standards and interpretations

At the date of authorization of these consolidated financial statements, the IASB has issued the following new and revised standards, amendments and interpretations which are not yet effective for the year ended December 31, 2011.

• IFRS 7 (Amendment)	Enhanced disclosure on transfer of financial assets (i)
• IFRS 9	New financial instruments standard that replaces IAS 39 for classification and measurement of financial assets and financial liabilities (iv)
• IFRS 10	New standard to establish principles for the presentation and preparation of consolidated financial statements when an entity controls multiple entities (ii)
• IFRS 11	New standard to account for the rights and obligations in accordance with a joint arrangement (ii)
• IFRS 12	New standard for the disclosure of interests in other entities not within the scope of IFRS 9/IAS 39 (ii)
• IFRS 13	New standard on the measurement and disclosure of fair value (ii)
• IAS 1 (Amendment)	Presentation of other comprehensive income (iii)
• IAS 19 (Amendment)	Revised recognition and measurement of post-employment benefits (ii)
• IAS 28 (Amendment)	New standard issued that supercedes IAS 28 (2003) to prescribe the accounting for investments in associates and joint ventures (ii)
• IFRIC 20	New interpretation to prescribe the accounting for stripping costs in the production phase of a surface mine (ii)

(i) Effective for annual periods beginning on or after July 1, 2011
(ii) Effective for annual periods beginning on or after January 1, 2013
(iii) Effective for annual periods beginning on or after July 1, 2012
(iv) Effective for annual periods beginning on or after January 1, 2015

The Company is currently assessing these new and revised standard and interpretations to determine the potential impact on the consolidated financial statements.

3. Summary of significant accounting policies

3.1 Basis of consolidation

The Consolidated Financial Statements include the financial statements of the Company and its controlled subsidiaries (Note 27). 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 intercompany transactions, balances, income and expenses are eliminated in full on consolidation.

Non-controlling interests in the net assets of consolidated subsidiaries are identified separately from the Company's equity therein. Total comprehensive income of the Company's subsidiaries is attributed to the owners of the Company and to the non-controlling interests even if this results in the non-controlling interest having a deficit balance.

3. Summary of significant accounting policies continued

3.2 Business combinations

Acquisitions of businesses are accounted for using the acquisition method. The consideration transferred in a business combination is measured as the aggregate of the fair value (at the date of exchange) of the assets transferred, liabilities incurred or assumed and equity instruments issued by the Company in exchange for control of the acquiree. At the acquisition date, the identifiable assets acquired and the liabilities assumed are, with limited exceptions, recognized at their fair value. Acquisition-related costs are expensed and included in profit or loss.

Any contingent consideration payable is recognized at fair value at the acquisition date. If the contingent consideration is classified as equity, it is not remeasured and settlement is accounted for within equity. Otherwise, subsequent changes to the fair value of the contingent consideration are recognized in profit or loss.

Goodwill is initially measured at cost, being the excess of the aggregate of the consideration transferred and the amount recognized for non-controlling interest over the fair value of the identifiable net assets acquired and liabilities assumed. If this consideration is lower than the fair value of the identifiable net assets of the business acquired, the difference is recognized in profit or loss.

3.3 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 the Company operates.

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 prevailing at the dates of the 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.

3.4 Borrowing costs

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets. All other borrowing costs are expensed and included in finance costs.

3. Summary of significant accounting policies continued

3.5 Inventories

Coal inventories are measured at the lower of production cost and net realizable value. Production cost is determined by the weighted average method and includes direct and indirect labor, operating materials and supplies, processing costs, transportation costs and an appropriate portion of fixed and variable overhead expenses. Fixed and variable overhead expenses include depreciation and depletion. Net realizable value represents the future estimated selling price of the product, less estimated costs of completion and costs necessary to bring the product to sale.

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

3.6 Property, plant and equipment ("PPE")

PPE includes the Company's operating equipment and infrastructure, construction in progress and mineral properties. PPE is stated at cost less accumulated depreciation and depletion and accumulated impairment losses.

The cost of an item of operating equipment and infrastructure consists of the purchase price or construction cost, any costs directly attributable to bringing the asset to the location and condition necessary for its intended use, an initial estimate of the decommissioning liability and capitalized borrowing costs (Note 3.4).

Construction in progress is classified to the appropriate category of PPE when it is completed and is ready for its intended use.

All direct costs related to the acquisition of mineral property interests are capitalized on a property by property basis. The cost of mineral properties includes deferred stripping costs and decommissioning liabilities related to the reclamation of the Company's mineral properties.

Depreciation is recorded based on the cost of an item of PPE, less its estimated residual value, using the straight-line method or unit-of-production method over the following estimated useful lives:

• Mobile equipment	5 to 7 years
• Other operating equipment	1 to 10 years
• Buildings and roads	5 to 15 years
• Construction in progress	not depreciated
• Mineral properties	unit-of-production basis based on economically recoverable reserves (Note 3.7)

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 profit or loss.

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.

3. Summary of significant accounting policies continued

3.7 Mineral properties

On the commencement of commercial production, depletion of each mineral property is recorded on a unit-of-production basis using economically recoverable reserves as the depletion base.

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 operating equipment and infrastructure is completed
- operating results are being achieved in a consistent manner

However, the commercial 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.

3.8 Stripping costs

Stripping costs incurred during the development phase of a mine are added to PPE as mineral property costs. Stripping costs incurred during the commercial production phase are variable production costs that are included in the costs of inventory produced during the period incurred, unless the stripping activity can be shown to give rise to future benefits from the mineral property, in which case the stripping costs are added to the cost of mineral properties.

Future benefits arise when the 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.

3.9 Decommissioning, restoration and similar liabilities

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

3. Summary of significant accounting policies continued

3.10 Interests in joint ventures

A joint venture is a contractual arrangement whereby the Company and other parties undertake an economic activity that is subject to joint control. Joint control occurs when the strategic financial and operating policy decisions relating to the activities of the joint venture require unanimous consent of the parties sharing control.

Jointly controlled assets

A jointly controlled asset involves joint control and often joint ownership by the Company and other venturers of assets contributed to, or acquired for the purposes of, the joint venture, without the formation of a corporation, partnership or other entity.

Where the Company's activities are conducted through jointly controlled assets, the Company recognizes its proportionate share of the jointly controlled assets and liabilities it has incurred, its share of liabilities incurred jointly with the other venturers and related revenue and operating costs in the consolidated financial statements.

Jointly controlled entities

A jointly controlled entity is a corporation, partnership or other entity in which each venturer holds an interest.

The Company accounts for it interests in jointly controlled entities under the equity method. The Company's investment in the joint venture is carried in the statement of financial position at cost plus post acquisition changes in the Company's share of the net assets of the joint venture. Goodwill relating to the joint venture is included in the carrying amount of the investment and is neither amortized nor individually tested for impairment.

The profit or loss reflects the Company's share of the results of operations of the joint venture. Unrealized gains and losses resulting from transactions between the Company and the joint venture are eliminated to the extent of the interest in the joint venture.

3.11 Share-based payments

Share-based payment transactions

Employees (including directors and senior executives) of the Company receive a portion of their remuneration in the form of share-based payments, 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 the fair value of the share-based payment. Otherwise, share-based payments are measured at the fair value of goods or services received.

3. Summary of significant accounting policies continued

3.11 Share-based payments continued

Equity-settled transactions

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

The costs of equity-settled transactions are recognized, together with a corresponding increase in the share option reserve, over the period in which the performance and/or service conditions are fulfilled and end on the date on which the relevant employees become fully entitled to the award. The cumulative expense recognized for equity-settled transactions at each reporting date reflects the Company's best estimate of the number of equity instruments that will ultimately vest. No expense is recognized for awards that do not ultimately vest.

When 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 the modification.

3.12 Earnings per share

Basic earnings per share is calculated by dividing the profit or loss attributable to equity holders of the Company by the weighted average number of shares outstanding during the reporting period.

Diluted earnings per share is calculated by adjusting the profit or loss attributable to equity holders of the Company and the weighted average number of shares outstanding for the effects of all dilutive share equivalents. Dilutive share equivalents include stock options and convertible debt.

3.13 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 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.

3. Summary of significant accounting policies continued

3.13 Taxation continued

Deferred income tax continued

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

- where the deferred income tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of taxable temporary differences associated with investments in subsidiaries, associates and joint ventures, where the timing of the reversal of the temporary differences can be controlled by the parent, investor or venturer 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:

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

The carrying amount of deferred income tax assets is reviewed at 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 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 profit or loss.

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.

3. Summary of significant accounting policies continued

3.14 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 or 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 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 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.

Transaction 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.

3.15 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. At the end of each reporting period subsequent to initial recognition, financial liabilities classified as 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.

3. Summary of significant accounting policies continued

3.16 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.

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.

3.17 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.

Financial liabilities 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.

3. Summary of significant accounting policies continued

3.18 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 (or 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 periods.

3.19 Cash and cash equivalents

Cash and cash equivalents include cash at banks and short term money market instruments with original maturities of three months or less.

3.20 Revenue recognition

Revenue is recognized to the extent it is probable that the economic benefits will flow to the Company and the revenue can be reliably measured. Revenue is measured at the fair value of the consideration received or receivable, excluding discounts, rebates or duties. Revenue from the sale of goods is recognized when the significant risks and rewards of ownership pass to the buyer, collection is reasonably assured and the selling price is reasonably determinable.

Revenue from the sale of coal is recognized when the significant risks and rewards of ownership and effective control of the coal is transferred to the buyer and the selling prices are known or can be reasonably estimated. Revenue recognition generally occurs when the coal is loaded into customer trucks at mine-gate or, depending on the terms of the sales contract, when the coal is made available for loading at a bonded stockyard.

3. Summary of significant accounting policies continued

3.21 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 a finance cost.

3.22 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.

3.23 Significant accounting judgments and estimates

The preparation of these financial statements requires management to make judgments 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 judgments 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 judgments and estimates. Actual outcomes may differ from these estimates.

The most significant estimates relate to the valuation of embedded derivatives and determination of their expected life; decommissioning liabilities; property, plant and equipment, including economically recoverable reserves, 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 judgments relate to the recoverability of capitalized amounts; accounting for stripping costs; recognition of deferred tax assets and liabilities; accounting for long term investments; determination of the commencement of commercial production; and the determination of the economic viability of a project.

4. Segmented information

The Company's one reportable operating segment is its Mongolian Coal Division. The Company's Chief Executive Officer (chief operating decision maker) reviews the Mongolian Coal Division's discrete financial information in order to make decisions about resources to be allocated to the segment and to assess its performance. The division is principally engaged in coal mining, development and exploration in Mongolia.

The Company's Corporate Division does not earn revenues and therefore does not meet the definition of an operating segment.

During the year ended December 31, 2011, the Mongolian Coal Division had eight active customers with the largest customer accounting for 46% of revenues, the second largest customer accounting for 22% of revenue and the other customers accounting for the remaining 32% of revenue.

The carrying amounts of the Company's assets, liabilities and reported income or loss, revenues and impairments analyzed by operating segment are as follows:

	Mongolian Coal Division	Unallocated (i)	Consolidated Total
Segment assets			
As at December 31, 2011	**$696,732**	**$223,591**	**$920,323**
As at December 31, 2010	342,591	619,275	961,866
Segment liabilities			
As at December 31, 2011	**$51,256**	**$152,887**	**$204,143**
As at December 31, 2010	25,408	257,568	282,976
Segment income/(loss)			
For the year ended December 31, 2011	**$(14,043)**	**$71,788**	**$57,745**
For the year ended December 31, 2010	(20,022)	(96,173)	(116,195)
Segment revenues			
For the year ended December 31, 2011	**$179,049**	**$–**	**$179,049**
For the year ended December 31, 2010	79,777	–	79,777
Impairment charge on assets (ii) (iii)			
For the year ended December 31, 2011	**$20,893**	**$–**	**$20,893**
For the year ended December 31, 2010	7,584	–	7,584

(i) The unallocated amount contains all amounts associated with the Corporate Division.

(ii) The impairment charge on assets for the year ended December 31, 2011 relates to trade and other receivables (Note 12), inventory (Note 14) and property, plant and equipment (Note 16).

(iii) The impairment charge on assets for the year ended December 31, 2010 relates to inventory (Note 14) and property, plant and equipment (Note 16).

4. Segmented information continued

The operations of the Company are located in Mongolia, Hong Kong and Canada.

	Mongolia	Hong Kong	Canada	Consolidated Total
Revenues				
For the year ended December 31, 2011	**$179,049**	**$–**	**$–**	**$179,049**
For the year ended December 31, 2010	79,777	–	–	79,777
Non-current assets				
As at December 31, 2011	**$519,003**	**$283**	**$106,434**	**$625,720**
As at December 31, 2010	277,201	401	108,027	385,629

5. Cost of sales

The Company's cost of sales consists of the following amounts:

	Year ended December 31,	
	2011	2010
Operating expenses	**$97,671**	$55,334
Share-based compensation expense (Note 22)	**1,942**	1,516
Depreciation and depletion	**27,730**	13,054
Cost of sales	**$127,343**	$69,904

6. Other operating expenses

The Company's other operating expenses consist of the following amounts:

	Year ended December 31,	
	2011	2010
Public infrastructure	**$8,069**	$5,952
Sustainability and community relations	**1,017**	718
Foreign exchange gain	**(790)**	(1,611)
Provision for doubtful trade and other receivables (Note 12)	**1,892**	–
Impairment of inventories (Note 14)	**2,396**	5,751
Impairment of property, plant and equipment (Note 16)	**16,605**	1,833
Other operating expenses	**$29,189**	$12,643

7. Administration expenses

The Company's administration expenses consist of the following amounts:

	Year ended December 31,	
	2011	2010
Corporate administration	**$7,136**	$6,020
Legal and professional fees	**4,279**	3,752
Salaries and benefits	**5,538**	4,728
Share-based compensation expense (Note 22)	**11,474**	10,820
Depreciation	**322**	118
Administration expenses	**$28,749**	$25,438

8. Evaluation and exploration expenses

The Company's evaluation and exploration expenses consist of the following amounts:

	Year ended December 31,	
	2011	2010
Assaying	**$756**	$342
Drilling and trenching	**21,842**	11,705
Geological	**1,314**	876
Geophysics	**1,485**	1,697
License fees	**1,085**	1,223
Depreciation	**–**	47
Salaries and benefits	**161**	127
Share-based compensation expense (Note 22)	**994**	924
Overhead and other	**4,131**	1,828
Evaluation and exploration expenses	**$31,768**	$18,769

9. Finance costs and income

The Company's finance costs consist of the following amounts:

	Year ended December 31,	
	2011	2010
Loss on partial conversion of convertible debenture (Note 19)	**$–**	$151,353
Interest expense on convertible debenture (Note 19)	**9,137**	24,294
Mark to market loss on FVTPL investments (Note 13)	**3,091**	–
Interest expense on line of credit facility (Note 18)	**351**	131
Accretion of decommissioning liability	**186**	77
Finance costs	**$12,765**	$175,855

The Company's finance income consists of the following amounts:

	Year ended December 31,	
	2011	2010
Fair value gain on embedded derivatives in convertible debenture (Note 19)	**$106,489**	$100,637
Mark to market gain on FVTPL investments (Note 13)	**–**	870
Interest income	**1,243**	2,441
Finance income	**$107,732**	$103,948

10. Taxes

10.1 Income tax recognized in profit or loss

A reconciliation between the Company's tax recovery and the product of the Company's income or loss from operations before tax multiplied by the Company's domestic tax rate is as follows:

	Year ended December 31,	
	2011	2010
(Income)/loss before tax	**$(56,967)**	$118,884
Statutory tax rate	**26.50%**	28.50%
Income tax expense/(recovery) based on combined Canadian federal and provincial statutory rates	**15,096**	(33,882)
Deduct:		
Lower effective tax rate in foreign jurisdictions	**502**	1,905
Tax effect of tax losses and temporary differences not recognized	**12,281**	2,789
Non-taxable (income)/non-deductible expenses	**(28,657)**	24,708
Effect of change in future tax rates	**–**	1,791
Income tax recovery	**$(778)**	$(2,689)

10. Taxes continued

10.2 Income tax recognized in other comprehensive income

	Year ended December 31,	
	2011	2010
Fair value remeasurement of available-for-sale assets	**$(1,600)**	$3,966
Deferred tax (recovery)/expense	**$(1,600)**	$3,966

10.3 Deferred tax balances

The Company's deferred tax assets/(liabilities) consist of the following amounts:

	As at December 31,	
	2011	2010
Property, plant and equipment	**$8,647**	$2,880
Other assets	**10,913**	8,562
Available-for-sale financial assets	**(2,366)**	(3,966)
Total deferred tax balances	**$17,194**	$7,476

10.4 Unrecognized deductible temporary differences and unused tax losses

The Company's deductible temporary differences and unused tax losses for which no deferred tax asset is recognized consist of the following amounts:

	As at December 31,	
	2011	2010
Non-capital losses	**$119,212**	$77,076
Capital losses	**63,649**	25,075
Deductible temporary differences	**107,997**	28,928
Total unrecognized amounts	**$290,858**	$131,079

10.5 Expiry dates

The expiry dates of the Company's unused tax losses are as follows:

		As at December 31, 2011		
		Local currency	**U.S. Dollar Equivalent**	**Expiry dates**
Non-capital losses				
Canada	Cdn$	112,781	**$110,602**	2014–2031
Hong Kong	HK$	66,342	**8,539**	indefinite
Singapore	SG$	92	**71**	indefinite
			$119,212	
Capital losses				
Canada	Cdn$	64,903	**$63,649**	indefinite

11. Earnings/(loss) per share

11.1 Basic earnings/(loss) per share

The calculation of basic earnings/(loss) per share is based on the following data:

	Year ended December 31,	
	2011	2010
Net income/(loss) for the year	**$57,745**	$(116,195)
Weighted average number of shares	**182,970**	176,529
Basic income/(loss) per share	**$0.32**	$(0.66)

11.2 Diluted earnings/(loss) per share

The diluted earnings/(loss) per share reflects the potential dilution of common share equivalents, such as outstanding stock options and convertible debt, in the weighted average number of common shares outstanding during the period, if dilutive.

The calculation of diluted earnings/(loss) per share is based on the following data:

	Year ended December 31,	
	2011	2010
Income/(loss)		
Net income/(loss) for the year	**$57,745**	$(116,195)
Interest on convertible debenture	**9,137**	– (i)
Fair value gain on convertible debenture	**(106,489)**	– (i)
Diluted loss for the year	**$(39,607)**	$(116,195)
Number of shares		
Weighted average number of shares	**182,970**	176,529
Convertible debenture	**20,931**	– (i)
Diluted weighted average number of shares	**203,901**	176,529
Diluted loss per share	**$(0.19)**	$(0.66)

(i) The convertible debenture was anti-dilutive for this period

Potentially dilutive items not included in the calculation of diluted earnings/(loss) per share for the year ended December 31, 2011, were 10,768 stock options that were anti-dilutive.

12. Trade and other receivables

The Company's trade and other receivables consist of the following amounts:

	As at December 31,	
	2011	2010
Trade receivables	**$64,051**	$15,297
VAT/GST receivable	**144**	14,541
Insurance proceeds receivable	**12,913**	–
Other receivables	**3,177**	408
Total trade and other receivables	**$80,285**	$30,246

The aging of the Company's trade and other receivables is as follows:

	As at December 31,	
	2011	2010
Less than 1 month	**$50,824**	$15,604
1 to 3 months	**3,337**	1,869
3 to 6 months	**23,699**	2,600
Over 6 months	**2,425**	10,173
Total trade and other receivables	**$80,285**	$30,246

For the year ended December 31, 2011, the Company recorded a $1,892 loss provision on one uncollectible trade receivable (2010: $nil). The Company anticipates full recovery of its remaining outstanding trade and other receivables; therefore, no further loss provisions have been recorded in respect of the Company's trade and other receivables. The Company's exposure to credit risk on its trade and other receivables is further disclosed in Note 26.

Included in trade and other receivables are amounts due from related parties which are further disclosed in Note 27. The amounts due from related parties are unsecured, interest free and repayable upon written notice from the Company.

13. Investments

The Company's investments consist of the following amounts:

	As at December 31,	
	2011	2010
Short term investments at fair value		
Money market investments (i)	**$ –**	$17,529
Long term investments at fair value		
Money market investments (ii)	**44,967**	45,173
Investment in Kangaroo Resources Limited (iii)	**7,431**	10,235
Investment in Aspire Mining Limited (iv)	**46,837**	52,008
Equity-accounted investment in joint venture		
Investment in RDCC LLC	**3**	–
	99,238	107,416
Total short and long term investments	**$99,238**	$124,945

(i) Money market investments with maturities greater than ninety days and less than one year
(ii) Money market investments with maturities greater than one year
(iii) At December 31, 2011, the Company owned 1.5% of Kangaroo's issued and outstanding shares
(iv) At December 31, 2011, the Company owned 19.9% of Aspire's issued and outstanding shares

13.1 Investment in Kangaroo Resources Limited

Kangaroo Resources Limited ("Kangaroo") is a company listed on the Australian Stock Exchange. Kangaroo's primary focus is its coal projects in Indonesia. The Company classifies its investment in Kangaroo as FVTPL with any change in value being recognized in profit or loss. For the year ended December 31, 2011, the Company recognized an unrealized mark to market loss of $2,804 related to its investment in Kangaroo (2010: gain of $360).

13.2 Investment in Aspire Mining Limited

Aspire Mining Limited ("Aspire") is a company listed on the Australian Stock Exchange. Aspire's primary focus is its mineral exploration licenses in Mongolia, particularly those pertaining to the Ovoot Coking Coal Project. The Company classifies its investment in Aspire as an available-for-sale financial asset with any change in value being recognized in other comprehensive income. For the year ended December 31, 2011, the Company recognized an unrealized loss of $11,202, net of tax, in other comprehensive income related to its investment in Aspire (2010: gain of $27,761).

13.3 Investment in RDCC LLC

The Company has a 40% interest in RDCC LLC, a jointly controlled entity. RDCC LLC has signed a concession agreement with the State Property Committee of Mongolia to construct a paved highway from the Company's Ovoot Tolgoi Mine to the Mongolia-China border. The concession agreement is structured as a 15-year build, operate and transfer agreement.

RDCC LLC did not have significant operations during the year ended December 31, 2011; therefore, summary financial statement information has not been disclosed.

14. Inventories

The Company's inventories consist of the following amounts:

	As at December 31,	
	2011	2010
Coal stockpiles	**$6,107**	$2,395
Materials and supplies	**46,336**	23,765
Total inventories	**$52,443**	$26,160

The cost of inventories recognized as an expense for the year ended December 31, 2011 is $116,975 (2010: $69,842).

Other operating expenses for the year ended December 31, 2011 includes $2,396 of impairments of materials and supplies inventory related to the Company's Liebherr 996 shovel derecognized during the year (Note 16) and other mobile equipment derecognized during the year.

Other operating expenses for the year ended December 31, 2010 includes $5,246 of impairments of coal stockpile inventory and $505 of impairments of materials and supplies inventory related to mobile equipment derecognized during the year.

As at December 31, 2011, the Company anticipates the entire coal stockpile balance of $6,107 will be realized within twelve months.

15. Prepaid expenses and deposits

The Company's prepaid expenses and deposits consist of the following amounts:

	As at December 31,	
	2011	2010
Vendor pre-payments	**$5,754**	$7,209
Ejin Jinda toll coal washing pre-payment	**25,168**	–
Other prepaid expenses and deposits	**7,386**	3,055
Total short term prepaid expenses and deposits	**38,308**	10,264
Ejin Jinda toll coal washing pre-payment	**8,389**	–
Total short and long term prepaid expenses and deposits	**$46,697**	$10,264

15. Prepaid expenses and deposits continued

15.1 Ejin Jinda toll coal washing pre-payment

During the year ended December 31, 2011, the Company entered into an agreement with Ejinaqi Jinda Coal Industry Co. Ltd ("Ejin Jinda"), a subsidiary of China Mongolia Coal Co. Ltd., to toll wash coal from the Ovoot Tolgoi Mine. The agreement has a duration of 5-years from commencement (expected in the second quarter of 2012) and provides for an annual wet washing capacity of approximately 3.5 million tonnes of input raw coal.

Pursuant to the terms of the agreement, the Company prepaid $33,557 of toll coal washing fees of which $25,168 is expected to be applied against toll coal washing fees in 2012, with the remaining $8,389 to be applied against fees in 2013.

16. Property, plant and equipment

The Company's property, plant and equipment consist of the following amounts:

	Mobile equipment	Other operating equipment	Buildings and roads	Mineral properties	Construction in progress	Total
Cost						
As at December 31, 2010	$217,433	$7,264	$14,249	$38,054	$16,138	$293,138
Additions	**145,767**	**3,190**	**8,458**	**56,588**	**90,847**	**304,850**
Disposals	**(26,408)**	**(132)**	**–**	**–**	**–**	**(26,540)**
Reclassifications	**–**	**–**	**8,448**	**–**	**(8,448)**	**–**
As at December 31, 2011	**$336,792**	**$10,322**	**$31,155**	**$94,642**	**$98,537**	**$571,448**
Accumulated depreciation and impairment charges						
As at December 31, 2010	$(20,915)	$(2,052)	$(2,673)	$(727)	$–	$(26,367)
Charge for the period	**(31,837)**	**(1,563)**	**(1,958)**	**(3,010)**	**–**	**(38,368)**
Impairment charges	**(13,550)**	**–**	**–**	**–**	**(15,968)**	**(29,518)**
Eliminated on disposals	**21,255**	**83**	**–**	**–**	**–**	**21,338**
As at December 31, 2011	**$(45,047)**	**$(3,532)**	**$(4,631)**	**$(3,737)**	**$(15,968)**	**$(72,915)**
Carrying amount						
As at December 31, 2010	$196,518	$5,212	$11,576	$37,327	$16,138	$266,771
As at December 31, 2011	**$291,745**	**$6,790**	**$26,524**	**$90,905**	**$82,569**	**$498,533**

16. Property, plant and equipment continued

16.1 Borrowing costs

For the year ended December 31, 2011, the Company capitalized borrowing costs of $10,939 (2010: $602) into construction in progress.

16.2 Impairment losses

All impairment charges and related insurance recoveries are recorded in the Company's other operating expenses.

For the year ended December 31, 2011, the Company recorded $16,605 of impairment charges, net of insurance proceeds receivable, to reduce various items of property, plant and equipment to their recoverable amounts. The impairments relate to the following items of property, plant and equipment:

- Liebherr 996 Shovel – the Liebherr 996 Shovel was damaged in a fire and an impairment charge of $11,086 was recorded to derecognize the full carrying amount of the asset and its related capital spares. The Company recorded net insurance proceeds of $12,913 in trade and other receivables, which resulted in a gain of $1,827.
- Terex TR100 Haul Trucks – the Terex TR100 Haul Trucks are expected to be replaced in 2012 with larger and more efficient haul trucks. The Company recorded an impairment charge of $2,464 to reduce their carrying amount to their estimated recoverable amount.
- Construction in progress – various capitalized construction projects were reviewed for impairment and it was determined that certain costs associated with these projects were not expected to be recovered. These construction projects included expenditures on mine access roads and infrastructure and mine infrastructure feasibility study costs. The Company recorded an impairment charge of $15,968 to reduce the carrying amount of these construction projects to $nil.

For the year ended December 31, 2010, the Company decided to replace its Liebherr 994 shovel to increase fleet flexibility and recorded an impairment charge of $1,833 to reduce its carrying amount to its estimated recoverable amount.

17. Trade and other payables

Trade and other payables of the Company consist of amounts outstanding for trade purchases relating to coal mining, development and exploration activities and mining royalties payable. The usual credit period taken for trade purchases is between 30 to 90 days.

The aging of the Company's trade and other payables is as follows:

	As at December 31,	
	2011	2010
Less than 1 month	**$52,032**	$24,006
1 to 3 months	**76**	33
3 to 6 months	**105**	72
Over 6 months	**22**	26
Total trade and other payables	**$52,235**	$24,137

Included in trade and other payables are amounts due from related parties which are further disclosed in Note 27.

18. Line of credit facility

The Company has a twelve month revolving line of credit facility with Golomt Bank in Mongolia. The maximum draw-down available is $3,500 and 8.1 billion Mongolian Tugrik (approximately $5,800) and the line of credit bears interest at 11% for any U.S. Dollar amounts outstanding and 12% for any Mongolia Tugrik amounts outstanding. The line of credit is secured by equipment in Mongolia to a value of not less than 150% of the total facility amount. The line of credit facility was renewed with the same terms on January 19, 2012.

The line of credit facility is used by the Company's Mongolian Coal Division as part of its working capital management.

There were no amounts due under the line of credit facility at both December 31, 2011 and December 31, 2010.

19. Convertible debenture

19.1 Key commercial terms

On November 19, 2009, the Company issued a convertible debenture to a wholly owned subsidiary of the China Investment Corporation ("CIC") for $500,000. 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 nine Board members of which none were elected by CIC.
- 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.
- 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.

19. Convertible debenture continued

19.1 Key commercial terms continued

The key commercial terms of the financing include:

- 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 Mines' ownership stake in the Company. At December 31, 2011 Ivanhoe Mines owned directly and indirectly approximately 58% 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.

19.2 Debt host and embedded derivatives

The convertible debenture is presented as a liability since it contains no equity components. 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 and is measured at amortized cost using the effective interest rate method and the embedded derivatives are classified as FVTPL and all changes in fair value are recorded in profit or loss. The difference between the debt host component and the principal amount of the loan outstanding is accreted to profit or loss over the expected life of the convertible debenture.

The embedded derivatives were valued upon initial measurement and subsequent periods 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 include: 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. Dollar) and spot foreign exchange rates.

19.3 Partial conversion

Pursuant to the debenture conversion terms, the Company had the right to call for the conversion of up to $250,000 of the debenture upon achieving a public float of 25% of its common shares based on a conversion price of the lower of Cdn$11.88 and the 50-day volume-weighted average price ("VWAP"). On March 29, 2010, the Company exercised this right and completed the conversion of $250,000 of the convertible debenture into 21,471 shares at a conversion price of $11.64 (Cdn$11.88). On March 29, 2010, the Company also settled the accrued interest payable in shares on the converted $250,000 by issuing 90 shares for the $1,436 in accrued interest converted at the 50-day VWAP conversion price of $15.97 (Cdn$16.29). On April 1, 2010, the Company also settled the outstanding accrued interest payable in cash on the converted debt of $250,000 with a cash payment of $5,742. A loss of $151,353 was recognized in finance costs upon partial conversion of the debt for the year ended December 31, 2010.

19. Convertible debenture continued

19.4 Valuation assumptions

The assumptions used in the Company's valuation models as at December 31, 2011 and 2010 are as follows:

	As at December 31,	
	2011	2010
Floor conversion price	**Cdn$8.88**	Cdn$8.88
Ceiling conversion price	**Cdn$11.88**	Cdn$11.88
Historical volatility	**71%**	73%
Risk free rate of return	**2.41%**	3.48%
Foreign exchange spot rate (U.S. Dollar to Cdn$)	**0.98**	1.01
Forward foreign exchange rate curve (U.S. Dollar to Cdn$)	**0.96–1.01**	0.97–1.14

19.5 Presentation

Based on the Company's valuations as at December 31, 2011, the fair value of the embedded derivatives decreased by $106,489 compared to December 31, 2010. This decrease was recorded as finance income for the year ended December 31, 2011.

For the year ended December 31, 2011, the Company also recorded interest expense of $20,076 (2010: $24,896) related to the convertible debenture of which $10,939 was capitalized as borrowing costs and the remaining $9,137 was recorded as finance costs. The interest expense consists of the interest at the contract rate and the accretion of the debt host component of the convertible debenture. To calculate the interest expense, the Company uses the contract life of 30 years and an effective interest rate of 22.2%.

The movements of the amounts due under the convertible debenture are as follows:

	Year ended December 31,	
	2011	2010
Balance, beginning of year	**$251,810**	$547,063
Interest expense on convertible debenture	**20,076**	24,896
Decline in fair value of embedded derivatives	**(106,489)**	(100,637)
Loss on conversion of convertible debenture	**–**	151,353
Conversion of convertible debenture	**–**	(347,643)
Interest paid	**(20,011)**	(23,222)
Balance, end of year	**$145,386**	$251,810

The convertible debenture balance consists of the following amounts:

	As at December 31,	
	2011	2010
Debt host	**$90,696**	$90,621
Fair value of embedded derivatives	**48,389**	154,877
Interest payable	**6,301**	6,312
Convertible debenture	**$145,386**	$251,810

20. Decommissioning liability

At December 31, 2011, the decommissioning liability primarily relates to reclamation and closure costs of the Company's Ovoot Tolgoi Mine in Mongolia.

The Ovoot Tolgoi Mine decommissioning liability is calculated as the net present value of the estimated future reclamation and closure costs, which at December 31, 2011 total $15,211 (2010: $8,840). The estimated future reclamation and closure costs are discounted at 10.5% per annum (2010: 8.0% per annum) to determine the year end decommissioning liability. The settlement of the decommissioning liability will occur through to 2024.

The decommissioning liability transactions during the years ended December 31, 2011 and 2010 were as follows:

	Year ended December 31,	
	2011	2010
Balance, beginning of year	**$3,063**	$735
Additions	**907**	2,251
Accretion	**186**	77
Balance, end of year	**$4,156**	$3,063

21. Share capital

The Company has authorized an unlimited number of common and preferred shares with no par value. At December 31, 2011, the Company had 181,364 common shares outstanding (2010: 183,604) and no preferred shares outstanding (2010: nil).

During the year ended December 31, 2011, the Company repurchased 3,300 common shares on the Toronto Stock Exchange and Hong Kong Stock Exchange (2010: 911 common shares) at an average price of $9.98 per share. As at December 31, 2011, the Company had cancelled 3,256 of the repurchased common shares. The remaining 44 common shares were cancelled in January 2012.

The weighted average share price for the year ended December 31, 2011 was Cdn$11.74 (2010: Cdn$13.72).

22. Share-based payments

22.1 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 17, 2011, 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.

22. Share-based payments continued

22.1 Stock option plan continued

The stock option plan permits the Board of Directors of the Company to set the terms for each stock option grant, however, the general terms of stock options granted under the amended plan include a maximum exercise period of 5 years and a vesting period of 3 years with 33% of the grant vesting on the first anniversary of the grant, 33% vesting on the second anniversary of the grant and 34% vesting on the third anniversary of the grant. The options granted in the year ended December 31, 2011, were granted with a weighted average maximum exercise period of 5.00 years (2010: 5.00 years) and a weighted average vesting period of 1.92 years (2010: 1.88 years).

For the year ended December 31, 2011, the Company granted 3,493 stock options (2010: 3,446) to officers, employees, directors and other eligible persons at exercise prices ranging from Cdn$9.43 to Cdn$14.09 (2010: Cdn$9.79 to Cdn$15.09) and expiry dates ranging from January 8, 2016 to August 15, 2016 (2010: February 8, 2015 to November 15, 2015). The weighted average fair value of the options granted in the year ended December 31, 2011, was estimated at $5.59 (Cdn$5.47) (2010: $5.83, Cdn$6.07) per option at the grant date using the Black-Scholes option pricing model. The weighted average assumptions used for the calculation were as follows:

	Year ended December 31,	
	2011	2010
Risk free interest rate	**1.66%**	2.17%
Expected life	**3.5 years**	3.6 years
Expected volatility (i)	**67.62%**	79.54%
Expected dividend per share	**$nil**	$nil

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

A share-based compensation expense of $18,218 for the options granted in the year ended December 31, 2011 (2010: $19,867) will be amortized over the vesting period, of which $6,077 was recognized in the year ended December 31, 2011 (2010: $5,097).

The total share-based compensation expense recognized for the year ended December 31, 2011 was $14,410 (2010: $13,260). Share-based compensation of $11,474 (2010: $10,820) has been allocated to administration expenses, $1,942 (2010: $1,516) has been allocated to cost of sales and $994 (2010: $924) has been allocated to evaluation and exploration expenses.

22. Share-based payments continued

22.2 Outstanding stock options

The option transactions under the stock option plan for the years ended December 31, 2011 and 2010 are as follows:

	Year ended December 31, 2011		Year ended December 31, 2010	
	Number of options	**Weighted average exercise price (Cdn$)**	Number of options	Weighted average exercise price (Cdn$)
Balance, beginning of year	**9,276**	**$10.82**	7,254	$9.11
Options granted	**3,493**	**10.54**	3,446	12.48
Options exercised	**(743)**	**6.89**	(1,099)	4.04
Options forfeited	**(1,258)**	**13.13**	(325)	13.31
Balance, end of year	**10,768**	**$10.73**	9,276	$10.82

The stock options outstanding and exercisable as at December 31, 2011 are as follows:

	Options Outstanding			**Options Exercisable**		
Exercise price (Cdn$)	**Options outstanding**	**Weighted-average exercise price (Cdn$)**	**Weighted-average remaining contractual life (years)**	**Options outstanding and exercisable**	**Weighted-average exercise price (Cdn$)**	**Weighted-average remaining contractual life (years)**
$4.81 – $6.00	**1,537**	**$5.55**	**1.16**	**1,537**	**$5.55**	**1.16**
$7.16 – $11.24	**4,258**	**9.37**	**4.13**	**1,069**	**8.77**	**3.18**
$11.46 – $14.25	**4,039**	**12.80**	**3.26**	**1,978**	**12.74**	**2.86**
$15.07 – $18.86	**934**	**16.43**	**1.92**	**800**	**16.66**	**1.72**
	10,768	**$10.73**	**3.19**	**5,384**	**$10.48**	**2.27**

23. Reserves

23.1 Share option reserve

The Company's share option reserve relates to stock options granted by the Company to officers, employees, directors and other eligible persons under its stock option plan. Details about the Company's share-based payments are further disclosed in Note 22.

The share option reserve transactions for the years ended December 31, 2011 and 2010 are as follows:

	Year ended December 31,	
	2011	2010
Balance, beginning of year	**$32,360**	$22,300
Share-based compensation charged to operations	**14,410**	13,260
Exercise of share options	**(2,627)**	(3,200)
Balance, end of year	**$44,143**	$ 32,360

23. Reserves continued

23.2 Investment revaluation reserve

The Company's investment revaluation reserve represents the cumulative gains and losses arising on the revaluation of available-for-sale financial assets that have been recognized in other comprehensive income.

The investment revaluation reserve transactions for the years ended December 31, 2011 and 2010 are as follows:

	Year ended December 31,	
	2011	2010
Balance, beginning of year	**$27,761**	$–
Gain/(loss) arising on revaluation of available-for-sale financial assets	**(12,802)**	31,727
Deferred income tax relating to revaluation of available-for-sale financial assets	**1,600**	(3,966)
Balance, end of year	**$16,559**	$27,761

24. Accumulated deficit and dividends

At December 31, 2011, the Company has accumulated a deficit of $398,820 (2010: $442,791).

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

25. 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, acquire previously issued 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, 2011, the Company's capital structure consists of convertible debt (Note 19) and the equity of the Company (Note 21). The Company is not subject to any externally imposed capital requirements. In order to maximize ongoing development efforts, the Company does not pay dividends.

For the year ended December 31, 2011, there were no significant changes in the processes used by the Company or in the Company's objectives and policies for managing its capital. As at December 31, 2011, the Company's available capital resources, consisting of cash and cash equivalents and long term money market investments, total $168,534. As at December 31, 2011, the Company's total liabilities are $204,143. The Company believes that sufficient capital resources are available from its existing capital resources and from future operations to support further expansion and development of its mining assets.

26. Financial instruments

26.1 Categories of financial instruments

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

	As at December 31,	
	2011	2010
Financial assets		
Loans-and-receivables		
Cash and cash equivalents	**$123,567**	$492,038
Trade and other receivables (Note 12)	**80,285**	30,246
Available-for-sale		
Investment in Aspire (Note 13)	**46,837**	52,008
Fair value through profit or loss		
Investment in Kangaroo (Note 13)	**7,431**	10,235
Money market investments (Note 13)	**44,967**	62,702
Total financial assets	**$303,087**	$647,229
Financial liabilities		
Fair value through profit or loss		
Convertible debenture – embedded derivatives (Note 19)	**$48,389**	$154,877
Other-financial-liabilities		
Trade and other payables (Note 17)	**52,235**	24,137
Convertible debenture – debt host (Note 19)	**96,997**	96,933
Total financial liabilities	**$197,621**	$275,947

26.2 Fair value

The fair value of financial assets and financial liabilities measured 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 measured at amortized cost approximates their fair value.

The fair values of the Company's financial instruments classified as FVTPL or available-for-sale 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 Kangaroo, shares of Aspire and its money market investments are 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 19) is determined using a Monte Carlo simulation. None of the fair value change in the embedded derivatives for the year ended December 31, 2011 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.

26. Financial instruments continued

26.2 Fair value continued

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, 2011, the Company does not have any Level 3 financial instruments.

	Level 1	Level 2	Total
Financial assets at fair value			
Investment in Aspire	**$46,837**	**$–**	**$46,837**
Investment in Kangaroo	**7,431**	**–**	**7,431**
Money market investments	**44,967**	**–**	**44,967**
Total financial assets at fair value	**$99,235**	**$–**	**$99,235**
Financial liabilities at fair value			
Convertible debenture – embedded derivatives	**$–**	**$48,389**	**$48,389**
Total financial liabilities at fair value	**$–**	**$48,389**	**$48,389**

There were no transfers between Level 1, 2 and 3 for the year ended December 31, 2011.

26. Financial instruments continued

26.3 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 is exposed to foreign currency risk on its sales or purchases in currencies other than the U.S. Dollar. The Company manages this risk by matching receipts and payments in the same currency and monitoring.

The sensitivity of the Company's comprehensive income due to changes in the carrying values of monetary assets and liabilities denominated in foreign currencies is as follows. A positive number indicates an increase in comprehensive income, whereas a negative number indicates a decrease in comprehensive income.

	As at December 31,	
	2011	2010
Increase/decrease in foreign exchange rate		
+5%	**$4,414**	$4,006
–5%	**(4,414)**	(4,006)

Interest rate risk

The Company is exposed to interest rate risk on the variable rate of interest earned on its cash and cash equivalents and its long term money market investments. However, the rate of interest earned on these instruments is below 3% percent; therefore, the interest rate risk is not significant.

The Company's convertible debenture (Note 19) and line of credit facility (Note 18) accrue interest at fixed rates; therefore the Company is not exposed to interest rate risk on these instruments.

Credit risk

The Company is exposed to credit risk associated with its cash and cash equivalents, long term money market investments and trade and other receivables. The Company's maximum exposure to credit risk is equal to the carrying amount of these instruments.

The Company's credit risk on cash and cash equivalents and long term money market investments arises from default of the counterparty. The Company limits its exposure to counterparty credit risk on these assets by only dealing with financial institutions with high credit ratings.

The Company manages its credit risk on trade and other receivables by trading with recognized, creditworthy third parties. It is the Company's policy that all customers who wish to trade on credit terms are subject to credit verification procedures. In addition, the trade and other receivables balances are monitored on an ongoing basis and, if appropriate, the Company records provisions for uncollectible trade and other receivables.

The Company's exposure to credit risk has not changed significantly for the year ended December 31, 2011.

26. Financial instruments continued

26.3 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. Management closely monitors the Company's 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's capital resources available from its existing capital resources and from future operations, the Company has sufficient working capital for its present obligations, that is for at least the next twelve months commencing from December 31, 2011.

The Company's current and expected remaining contractual maturities for its financial liabilities with agreed repayment periods are as follows. The table includes 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
As at December 31, 2011				
Trade and other payables	**$52,235**	**$–**	**$–**	**$52,235**
Convertible debenture – cash interest (Note 19)	**8,000**	**8,000**	**32,000**	**48,000**
	$60,235	**$8,000**	**$32,000**	**$100,235**
As at December 31, 2010				
Trade and other payables	$24,137	$–	$–	$24,137
Convertible debenture – cash interest (Note 19)	8,000	8,000	48,000	64,000
	$32,137	$8,000	$48,000	$88,137

Commodity price risk

The Company is exposed to the risk of fluctuations in prevailing market prices for its coal products. 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, in most cases entering into three month coal contracts which fix the quantity and price of the Company's 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.

27. Related party transactions

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

Name	Country of incorporation	% equity interest As at December 31, 2011	2010
SouthGobi Resources (Hong Kong) Ltd.	Hong Kong	**100%**	100%
Dayarbulag LLC	Mongolia	**100%**	100%
SouthGobi Sands LLC	Mongolia	**100%**	100%
SGQ Coal Investment Pte. Ltd.	Singapore	**100%**	100%
SGQ Dayarcoal Mongolia Pte. Ltd.	Singapore	**100%**	100%

For the years ended December 31, 2011 and 2010, the Company had related party transactions with the following Companies related by way of directors or shareholders in common:

- Ivanhoe Mines – Ivanhoe Mines is the Company's parent company and at December 31, 2011 owned approximately 58% of the outstanding common shares of the Company. Ivanhoe Mines provides various administrative services to the Company on a cost-recovery basis. The Company also provides some office and investor relations services to Ivanhoe Mines in the Company's Hong Kong office and recovers the costs for those services on a cost-recovery basis.
- Global Mining Management ("GMM") – GMM is a private Company owned equally by seven companies, two of which include the Company and Ivanhoe Mines. GMM provides administration, accounting and other office services to the Company on a cost-recovery basis.
- Ivanhoe Capital Aviation LLC ("Ivanhoe Aviation") – Ivanhoe Aviation is a private company 100% owned by Ivanhoe Mines' Chief Executive Officer. Ivanhoe Aviation operates aircraft which are rented by the Company on a cost-recovery basis.
- I2MS.NET Pte. Ltd. ("I2MS") – I2MS is a private company 100% owned by Ivanhoe Mines. I2MS provides information technology and other related services to the Company on a cost-recovery basis.
- Ivanhoe Energy Inc. ("Ivanhoe Energy") – Ivanhoe Energy is a publicly listed company with two directors in common with the Company. The Company provides some office and investor relations services to Ivanhoe Energy in the Company's Hong Kong office and recovers the costs for those services on a cost-recovery basis.

27. Related party transactions continued

27.1 Related party expenses

The Company's related party expenses consist of the following amounts:

	Year ended December 31,	
	2011	2010
Corporate administration	**$1,990**	$3,832
Salaries and benefits	**1,389**	2,120
Related party expenses	**$3,379**	$5,952

The Company's related party expenses relate to the following related parties:

	Year ended December 31,	
	2011	2010
GMM	**$2,014**	$2,840
Ivanhoe Mines	**94**	252
Ivanhoe Aviation	**–**	1,725
I2MS	**1,271**	1,135
Related party expenses	**$3,379**	$5,952

27.2 Related party expense recoveries

The Company's expenses recovered from related parties consist of the following amounts:

	Year ended December 31,	
	2011	2010
Corporate administration	**$465**	$233

The Company's related party expense recoveries relate to the following related parties:

	Year ended December 31,	
	2011	2010
Ivanhoe Mines	**$311**	$156
Ivanhoe Energy	**154**	77
Related party expense recoveries	**$465**	$233

27. Related party transactions continued

27.3 Related party assets

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

	As at December 31,	
	2011	2010
Amounts due from GMM	**$238**	$238
Amounts due from Ivanhoe Mines	**26**	156
Amounts due from Ivanhoe Energy	**13**	38
Total assets due from related parties	**$277**	$432

27.4 Related party liabilities

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

	As at December 31,	
	2011	2010
Amounts payable to GMM	**$255**	$549
Amounts payable to Ivanhoe Mines	**–**	1
Amounts payable to I2MS	**189**	367
Total liabilities due to related parties	**$444**	$917

28. Key management personnel compensation

The remuneration of the Company's directors and other members of key management, who have the authority and responsibility for planning, directing and controlling the activities of the Company, consists of the following amounts:

	Year ended December 31,	
	2011	2010
Short-term benefits	**$3,493**	$2,800
Share-based payments	**9,147**	5,763
Total remuneration	**$12,640**	$8,563

29. Supplemental cash flow information

29.1 Non-cash financing and investing activities

The Company's non-cash investing and financing transactions are as follows:

	Year ended December 31,	
	2011	2010
Conversion of convertible debenture	**$–**	$347,643
Interest settlement on convertible debenture	**4,011**	1,436
Transfer of share option reserve upon exercise of options	**2,627**	3,200

29.2 Net change in non-cash working capital items

The net change in the Company's non-cash working capital items is as follows:

	Year ended December 31,	
	2011	2010
Increase in inventories	**$(27,672)**	$(15,814)
Increase in trade and other receivables	**(49,550)**	(15,810)
Increase in prepaid expenses and deposits	**(36,433)**	(3,713)
Increase in trade and other payables	**40,083**	12,262
Net change in non-cash working capital items	**$(73,572)**	$(23,075)

30. Commitments for expenditure

As at December 31, 2011, the Company's commitments that have not been disclosed elsewhere in the consolidated financial statements are as follows:

	As at December 31, 2011			
	Within 1 year	**2-3 years**	**Over 3 years**	**Total**
Capital expenditure commitments	**$70,322**	**$–**	**$–**	**$70,322**
Operating expenditure commitments	**18,416**	**276**	**–**	**18,692**
Commitments	**$88,738**	**$276**	**$–**	**$89,014**

31. Contingencies

Due to the size, complexity and nature of the Company's operations, various legal and tax matters arise in the ordinary course of business. In the opinion of management, at December 31, 2011 a provision for these matters is not required.

32. Subsequent event

On March 5, 2012, the Company entered into an agreement to sell its thermal coal property, the Tsagaan Tolgoi Deposit, to Modun Resources Limited ("Modun"), a company listed on the Australian Stock Exchange. Under the transaction, the Company expects to receive $30,000 of total consideration, comprising $7,500 up-front in cash, $12,500 up-front in Modun common shares and deferred consideration of an additional $10,000 also payable in Modun common shares.

The Tsagaan Tolgoi Deposit mineral property has a carrying amount of $nil at December 31, 2011 and 2010; therefore, the transaction does not impact the presentation of the Company's consolidated statement of financial position as at December 31, 2011. The income from the sale, net of selling costs, will be recognized in the statement of comprehensive income when the transaction closes in 2012.

33. Approval of the financial statements

The consolidated financial statements of SouthGobi Resources Ltd. for the year ended December 31, 2011 were approved and authorized for issue by the Board of Directors on March 19, 2012.

Appendix to the consolidated financial statements

December 31, 2011

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

Additional stock exchange information

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

A1. Income/(loss) for the year

Income/(loss) for the year has been arrived at after charging the following items:

	Year ended December 31,	
	2011	2010
Auditor's remuneration	**$275**	$279
Loss on disposal of property, plant and equipment	**3,005**	3,770
Depreciation		
Depreciation included in administration expenses	**322**	118
Depreciation included in exploration expenses	**–**	47
Depreciation included in cost of sales	**27,730**	13,054
Total depreciation	**$28,052**	$13,219
Staff costs		
Directors' emoluments – executive directors (Note A2)	**$2,928**	$1,798
Directors' emoluments – non–executive directors (Note A2)	**1,900**	2,439
Other staff costs	**12,184**	11,288
Retirement benefit costs excluding directors	**–**	23
Staff costs included in administration expenses	**17,012**	15,548
Staff costs included in evaluation and exploration expenses	**1,155**	1,051
Total staff costs	**$18,167**	$16,599

A2. Director and employee emoluments

Directors' emoluments

The Company's directors' emoluments consist of the following amount:

	Year ended December 31,	
	2011	2010
Directors' fees	**$421**	$377
Other emoluments for executive and non-executive directors		
Salaries and other benefits	**926**	900
Share-based compensation	**3,481**	2,950
Retirement benefit contribution	**–**	10
Directors' emoluments	**$4,828**	$4,237

A2. Director and employee emoluments continued

Directors' emoluments continued

Year ended December 31, 2011 **Name of director**	**Directors' fees**	**Salaries and other benefits**	**Stock-based compensation**	**Retirement benefit contribution**	**Total**
Executive directors					
Alexander Molyneux	**$–**	**$926**	**$2,002**	**$–**	**$2,928**
Non-executive directors					
Peter Meredith	**$–**	**$–**	**$286**	**$–**	**$286**
John Macken	**–**	**–**	**167**	**–**	**167**
Pierre Lebel	**110**	**–**	**191**	**–**	**301**
André Deepwell	**88**	**–**	**167**	**–**	**255**
R. Edward Flood	**42**	**–**	**167**	**–**	**209**
R. Stuart (Tookie) Angus	**70**	**–**	**167**	**–**	**237**
Robert Hanson	**64**	**–**	**167**	**–**	**231**
Gordon Lancaster	**47**	**–**	**167**	**–**	**214**
	$421	**$–**	**$1,479**	**$–**	**$1,900**
Directors' emoluments	**$421**	**$926**	**$3,481**	**$–**	**$4,828**

Year ended December 31, 2010 **Name of director**	**Directors' fees**	**Salaries and other benefits**	**Stock-based compensation**	**Retirement benefit contribution**	**Total**
Executive directors					
Alexander Molyneux	$–	$802	$994	$2	$1,798
Non-executive directors					
Peter Meredith	$–	$98	$659	$–	$757
John Macken	–	–	296	–	296
Pierre Lebel	104	–	139	2	245
André Deepwell	86	–	139	2	227
R. Edward Flood	34	–	139	1	174
R. Stuart (Tookie) Angus	65	–	139	2	206
Robert Hanson	57	–	139	–	196
Gordon Lancaster	31	–	306	1	338
	$377	$98	$1,956	$8	$2,439
Directors' emoluments	$377	$900	$2,950	$10	$4,237

Salaries and other benefits paid to Alexander Molyneux includes a bonus of $425 (2010: $300) paid in accordance with the Company's annual incentive plans.

A2. Director and employee emoluments continued

Five highest paid individuals

The five highest paid individuals included one director of the Company for the years ended December 31, 2011 and 2010. The emoluments of the remaining four highest paid individuals for the years ended December 31, 2011 and 2010, respectively are as follows:

	Year ended December 31,	
	2011	2010
Salaries and other benefits	**$1,828**	$1,511
Retirement benefit contribution	**–**	2
Share-based compensation	**7,064**	2,813
Total emoluments	**$8,892**	$4,326

The emoluments for the remaining four highest paid employees were within the following bands:

	Year ended December 31,	
	2011	2010
HK$ 6,000,001 to HK$ 6,500,000	**–**	1
HK$ 6,500,001 to HK$ 7,000,000	**1**	–
HK$ 8,500,001 to HK$ 9,000,000	**–**	1
HK$ 9,000,001 to HK$ 9,500,000	**–**	2
HK$ 15,000,001 to HK$ 15,500,000	**1**	–
HK$ 21,000,001 to HK$ 21,500,000	**1**	–
HK$ 25,000,001 to HK$ 25,500,000	**1**	–
	4	4

A3. Five year summary

The following table contains a five year summary of the Company's results, assets and liabilities:

	Year ended December 31,				
	2011	2010	2009	2008	2007
Revenue	**$179,049**	$79,777	$36,038	$3,126	$–
Gross profit	**51,706**	9,873	6,613	949	–
Net comprehensive income/(loss) attributable to equity holders of the Company	**$46,543**	$(88,434)	$(110,805)	$(69,576)	$(96,736)
Basic income/(loss) per share from continuing and discontinued operations	**$0.32**	$(0.66)	$(0.83)	$(0.54)	$(1.89)
Diluted income/(loss) per share from continuing and discontinued operations	**$(0.19)**	$(0.66)	$(0.83)	$(0.54)	$(1.89)

	As at December 31,				
	2011	2010	2009	2008	2007
Total assets	**$920,323**	$961,866	$560,684	$99,948	$5,610
Less: Total liabilities	**(204,143)**	(282,976)	(563,476)	(10,984)	(107,441)
Total net assets/(liabilities)	**$716,180**	$678,890	$(2,792)	$88,964	$(101,831)

A4. Share repurchases

During the year ended December 31, 2011, the Company repurchased its own shares on the Toronto Stock Exchange and Hong Kong Stock Exchange as follows:

Month of repurchase	Shares repurchased	Price per share		Aggregate consideration paid
		Highest	Lowest	
January 2011	**372**	14.69	12.32	**$5,294**
February 2011	**223**	16.02	14.51	**3,474**
March 2011	**–**	–	–	**–**
April 2011	**–**	–	–	**–**
May 2011	**239**	11.89	11.47	**2,777**
June 2011	**637**	11.25	10.10	**6,634**
July 2011	**11**	11.16	11.16	**122**
August 2011	**509**	10.08	8.96	**4,827**
September 2011	**651**	9.89	6.30	**5,623**
October 2011	**155**	7.10	5.82	**963**
November 2011	**113**	6.53	6.36	**726**
December 2011	**390**	7.17	5.78	**2,501**
	3,300			**$32,941**

As at December 31, 2011, the Company had cancelled 3,256 of the 3,300 shares repurchased and the remaining 44 common shares were cancelled in January 2012. None of the Company's subsidiaries repurchased, sold or redeemed any of the Company's shares during the year.

A5. Cash and cash equivalents

The Company's cash and cash equivalents are denominated in the following currencies:

	As at December 31,	
	2011	2010
Denominated in U.S. Dollars	**$114,941**	$486,403
Denominated in Hong Kong Dollars	**3,757**	3,666
Denominated in Canadian Dollars	**3,027**	1,182
Denominated in Mongolian Tugriks	**1,440**	148
Others	**402**	639
Cash and cash equivalents	**$123,567**	$492,038

Corporate information

Directors

Executive directors:

Mr. Alexander Molyneux

Non-executive directors:

Mr. Peter Meredith (Chairman)
Mr. John Macken

Independent non-executive directors:

Mr. Pierre Lebel (Lead Director)
Mr. André Deepwell
Mr. R. Stuart (Tookie) Angus
Mr. Robert Hanson
Mr. R. Edward Flood
Mr. W. Gordon Lancaster

Audit Committee

Mr. André Deepwell (Chair)
Mr. Pierre Lebel
Mr. W. Gordon Lancaster

Nominating and Corporate Governance Committee

Mr. Robert Hanson (Chair)
Mr. R. Stuart (Tookie) Angus
Mr. André Deepwell
Mr. Pierre Lebel
Mr. W. Gordon Lancaster
Mr. R. Edward Flood

Compensation and Benefits Committee

Mr. W. Gordon Lancaster (Chair)
Mr. R. Stuart (Tookie) Angus
Mr. André Deepwell
Mr. Pierre Lebel

Health, Environment, Safety and Social Responsibility Committee

Mr. Robert Hanson (Chair)
Mr. John Macken
Mr. Alexander Molyneux

Mergers and Acquisitions Committee

Mr. Pierre Lebel (Chair)
Mr. R. Stuart (Tookie) Angus
Mr. R. Edward Flood
Mr. W. Gordon Lancaster

Company Secretary

Beverly Ann Bartlett

Registered office

Suite 654, 999 Canada Place
Vancouver, B.C.
V6E 3K9

Principal place of business in Hong Kong

Unit B, 29F, Morrison Plaza,
9 Morrison Hill Road, Wan Chai,
Hong Kong

Principal bankers

Canada:

BMO Bank of Montreal

Hong Kong:

Standard Chartered Bank (Hong Kong) Limited

Principal share registrar

CIBC Mellon Trust Company
Suite 1600 – 1066 West Hastings Street
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V6E 3X1

PO Box 700, Station B,
Montreal, QC
H3B 3K3

Branch share registrar

Computershare Hong Kong Investor Services Limited
46F, Hopewell Centre
183 Queen's Road East
Wan Chai, Hong Kong

Independent auditor

Deloitte & Touche LLP

Website address

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