SouthGobi Resources

TSX: SGQ HKEX: 1878

ANNUAL REPORT 2016

FSC
www.fsc.org
MIX
Paper from responsible sources
FSC™ C008061

www.southgobi.com

SouthGobi Resources Ltd.
Annual Report 2016

Contents

SouthGobi Resources Ltd. (the "Company" or "SouthGobi") is focused on the exploration, development and production of its coking coal deposits in Mongolia's South Gobi Region. The Company has a 100% shareholding in SouthGobi Sands LLC, the Mongolian registered company that holds SouthGobi's mining and exploration licenses in Mongolia and operates the flagship Ovoot Tolgoi coal mine. Ovoot Tolgoi produces and sells coal to customers in China.

English text of this Annual Report shall prevail over the Chinese text in case of inconsistencies.

MESSAGE FROM THE CEO

SouthGobi has challenged through 2016 with improved operating and financial results although the situation faced by the Company remained difficult. The company has increased coal productions, expanded its customer base, improved its coal sales revenue, narrowed its gross loss and net loss, and enhanced its cash flow management. All these achievements are as a result of the valued contributions from SouthGobi's employees over the year, on behalf of the board and the management team, I would like to thank every staff member for their effort. We look forward to continue propelling the Company forward.

In the first half of 2016, the coal prices and market conditions in China remained weak, however, towards the second half, there is a modest recovery of the coal market as China implemented several national policies: i) to reduce its coal production in order to address the overcapacity issue in the medium term; ii) to reduce the number of working days of domestic coal miners; and iii) to disapprove of greenfield coal mine construction in the next few years. Following the implementation of these measures, the coal supply in China was under control and therefore the overall coal prices started to pick up along 2016. SouthGobi was able to benefit from these measures which resulted with the increase average selling price although the impact was partially offset by the depreciation of RMB against USD.

Throughout the year, Management continued to implement measures to improve operation efficiency and productivity while maintaining product quality. For instance, to reduce working capital by optimizing cash flow management, to enhance sales strategy by expanding the customer base, to improve the liquidity situation by obtaining more prepayments from customers, and utilizing the trade financing in order to speed up the collection cycle and lengthening the payable turnover cycle. The Company has also started engaging contract mining companies to enhance the flexibility of production level. Furthermore, the Company has formed a Strategic Advisory Board to provide non-binding strategic guidance and advice to the Board of Directors regarding ongoing business activities and initiatives to evaluate from an independent perspective.

In late 2016, the Company has entered into the Real Estate Project in Ulaanbaatar of Mongolia as a trade receivables settlement agreement from one of its customers in which 200 residential units and 40 car parks will be transferred to SouthGobi as a consideration valued at $12 million. The company believes that having this diversified business sector could bring additional revenue path with the sales are expected to commence in the second quarter of 2017.

Regarding the tax investigation case in Mongolia, the Company has made cash payment of $2.4 million during 2016 as partial settlement of the Tax Penalty. In November 2016, the Company has signed the operation agreement with Erdenese Tavan Tolgoi, which was approved by the Government of Mongolia, to perform mining operation equivalent to $8.3 million during November 2016 and February 2017, to further partially settle the Tax Penalty.

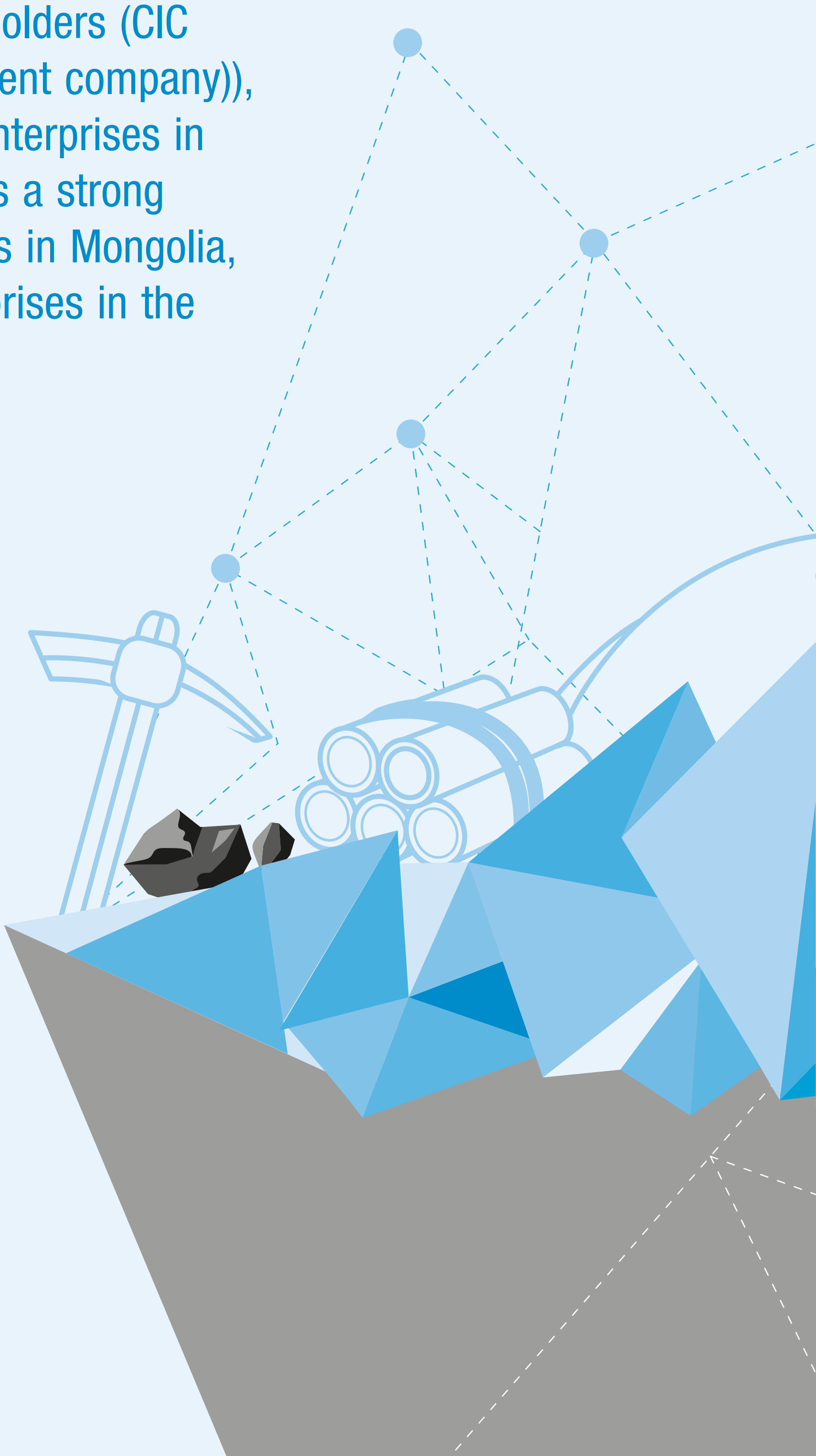
Looking forward to 2017, SouthGobi believe that it is well positioned to capture the resulting business opportunities between China and Mongolia, following the implementation of the "One Belt, One Road" program in China. The Company remains cautiously optimistic regarding the coal market which is expected to continue stabilizing which also depends on any further governmental policy to be implemented by China. The Company will continue to strive for revenue growth by enhancing our sales strategy and expanding the sales network. We will also start the coal washing operation to beneficiate a portion of its coal into washed coal products in order to meet increasing market demand for higher quality coal. Safety is still our top priority and we remain vigilant to ensure we continue to operate in a socially responsible manner. The Company is also evaluating various other business opportunities beside coal mining and coal trading which aims to widen the business profile and committed to contribute to the long term development of Mongolia.

On behalf of the Board of Directors and the Management team, I would like to thank all SouthGobi staff, the communities and authorities of Mongolia, our customers, suppliers and you our shareholders for all your support throughout these challenging times.

Aminbuhe
Executive Director and Chief Executive Officer

Bridge between Mongolia and China

The Company is well positioned to capture the resulting business opportunities between the two countries given i) strong strategic support from its largest shareholders (CIC and Cinda (Novel Sunrise's parent company)), which are both state-owned-enterprises in China; and ii) the Company has a strong operational record for ten years in Mongolia, being one of the largest enterprises in the country.



BOARD OF DIRECTORS

Ningqiao Li

Executive Chairman of the Board and Executive Director

Mr. Li, 53, was appointed to the Board of Directors on May 15, 2015 as a Non-Executive Director and became an Executive Director on September 17, 2015 when he was appointed Executive Chairman.

Mr. Li has approximately 30 years' experiences in enterprise management, corporate governance and strategic investment. He also has experience in the real estate, energy, and financial institution industries. In addition to his directorship with the Company, Mr. Li is the Senior Advisor of Convoy Investment Services Limited; a Hong Kong based securities company. Previously, Mr. Li was a Director of Novel Sunrise Investments Limited and China Orient Group Corporation Ltd., and held the positions of Senior Advisor of United Energy Group Limited as well as several senior management positions in China National Real Estate Development Group Corporation.

Mr. Li graduated from Tsinghua University and holds a Bachelor of Engineering Degree. Mr. Li is a member of the Canadian Institute of Corporate Directors.

Aminbuhe

Executive Director and Chief Executive Officer

Mr. Aminbuhe, 41, joined the Company as a Non-Executive Director on August 6, 2015 and became an Executive Director on September 1, 2015 upon his appointment to the position of Chief Executive Officer at that time.

He is a coal mining professional with diverse senior experience that includes sales and marketing, exploration, logistics, business development and Hong Kong public company disclosure requirements. Mr. Aminbuhe previously held the position of Executive Director at National United Resources Holding Limited ("NUR"); a Hong Kong listed commodity trading and investment company operating in China and Mongolia. Prior to his position at NUR, Mr. Aminbuhe was Chairman and President of Inner Mongolia Ejina Jin Yun Kun Tai Industrial Development Co. Ltd., a leading coal trading company operating in China and Mongolia. Mr. Aminbuhe also owned and operated Inner Mongolia Rong Chun Coal Co. Ltd., with its coal mine located in Inner Mongolia of China.

Mr. Aminbuhe graduated from the Beijing Institute of Technology with a Bachelor Degree in Management Engineering and is a member of the Canadian Institute of Corporate Directors.

BOARD OF DIRECTORS

Yulan Guo

Executive Director and Chief Financial Officer

Mr. Guo, 32, joined the Company as a Non-Executive Director on May 15, 2015 and became an Executive Director on July 26, 2015 upon his appointment to the position of interim Chief Executive Officer at that time. He acted in the capacity of interim Chief Executive Officer from July 26, 2015 to September 1, 2015 and assumed the role of Chief Financial Officer on September 1, 2015.

Mr. Guo commenced his career in 2008 with China International Capital Corporation Limited, the leading investment bank in the greater China market where he most recently held the position of Vice President of the Investment Banking Department.

Mr. Guo has extensive transaction experience in capital markets in mainland China, Hong Kong and the United States of America. He has arranged significant equity and debt financings and been involved in mergers and acquisitions. Mr. Guo has developed industry expertise in the financial and operational aspects of the metals and mining, power, and energy sectors. Previously, Mr. Guo was a Director of Novel Sunrise Investments Limited.

Mr. Guo graduated from Peking University where he obtained Master of Science and Bachelor of Science Degrees. He completed the Master of Business Administration program at the University of International Business and Economics in Beijing. Mr. Guo is a member of the Canadian Institute of Corporate Directors.

Joseph Belan

Independent Non-Executive Director

Mr. Belan, 43, joined the Board of Directors on August 16, 2016 as an independent Non-Executive Director.

Mr. Belan is the Chairman and founder of Novatrek Capital Gmblt, a corporate advisory and investment firm with the primary industry focus in the industrial and metals and mining sectors.

Prior to establishing Novatrek Capital in 2013, Mr. Belan was an investment banker specializing in the industrial and metals and mining sectors with each of Merrill Lynch, Goldman Sachs and Credit Suisse First Boston. He also served as Managing Director of Pala Investments Limited ("Pala"), a mining focused investment company and as part of his role with Pala, Mr. Belan was appointed as Interim Chief Executive Officer of Coalcorp Mining Inc. and directed its restructuring and asset divestment initiatives during 2009 and 2010. He also served as Executive Chairman of Norcast Castings, a global leader in engineered products for the mining industry. He has extensive experience in capital raising, restructuring, joint ventures and mergers and acquisitions for the mining sector.

Mr. Belan obtained a Degree in Honors Business Administration from the Richard Ivey School of Business at the University of Western Ontario. He is a member of the Canadian Institute of Corporate Directors.

BOARD OF DIRECTORS

Zhu Liu

Independent Non-Executive Director

Mr. Liu, 71, joined the Board of Directors on August 6, 2015 as an Independent Non-Executive Director.

Mr. Liu has had a distinguished career in the shipping industry spanning over 40 years. As former Deputy Chief Executive Officer and President of China Ocean Shipping (Group) Company ("COSCO"), Mr. Liu gained extensive operation and management experience derived from overseeing the company's large multinational logistics enterprises. This position also provided him with unique transportation and logistics industry expertise. While at COSCO, Mr. Liu led the debt restructuring of Orient Overseas Hong Kong Corporation on behalf of COSCO.

Mr. Liu studied in France, first at the Faculty of Arts of University of Paris from 1964 to 1967 and subsequently at the University of Grenoble. In 1987 Mr. Liu obtained the title of Senior Economist in China and in 1989 was a member of the China Strait Affairs Council. Mr. Liu is a member of the Canadian Institute of Corporate Directors.

Jin Lan Quan

Independent Non-Executive Director

Ms. Quan, 54, joined the Board of Directors on August 6, 2015 as an Independent Non-Executive Director.

Ms. Quan is an independent financial planner and business consultant based in Sydney, Australia. Prior to her current role, Ms. Quan developed extensive and diverse finance and audit experience during her time as an audit partner with Arthur Anderson in Sydney, Australia. Ms. Quan has extensive experiences in financial consulting services with specialist skills in external auditing, internal audit structuring, corporate financing and risk management and business acquisition.

Ms. Quan is a certified public accountant of China and a member of the Chinese Institute of Certified Public Accountants. She is also a Fellow of the Association of Chartered Certified Accountants of United Kingdom and a member of the Canadian Institute of Corporate Directors.

BOARD OF DIRECTORS

Mao Sun

Independent Non-Executive Director and Interim Lead Director

Mr. Sun, 40, joined the Board of Directors on November 5, 2015 as an Independent Non-Executive Director and was appointed as Interim Lead Director on August 16, 2016.

Mr. Sun is the founding partner of Mao & Ying LLP (formerly SunRonkai LLP), a private accounting firm offering tax, assurance and management consulting services.

Mr. Sun has over 15 years of experience in the accounting sector and has extensive knowledge of Canadian accounting standards, International Financial Reporting Standards and Canadian taxation laws. Mr. Sun has extensive experience with Canadian listed companies and was the Director and Chairman of the Audit Committee of Yalian Steel Corporation. Prior to founding SunRonkai LLP, Mr. Sun was the audit manager in Vancouver office of KPMG, an internationally recognized accounting firm.

Mr. Sun graduated from Columbia University in New York with a Master Degree of International Affairs, International Finance and Business and a Bachelor Degree in Computer Science from Nanjing University, China. Mr. Sun is a member of the Institute of Chartered Accountants of British Columbia, the Canadian Tax Foundation and the Canadian Institute of Corporate Directors.

Huiyi Wang

Non-Executive Director

Mr. Wang, 29, joined the Board of Directors on February 18, 2016 as a Non-Executive Director.

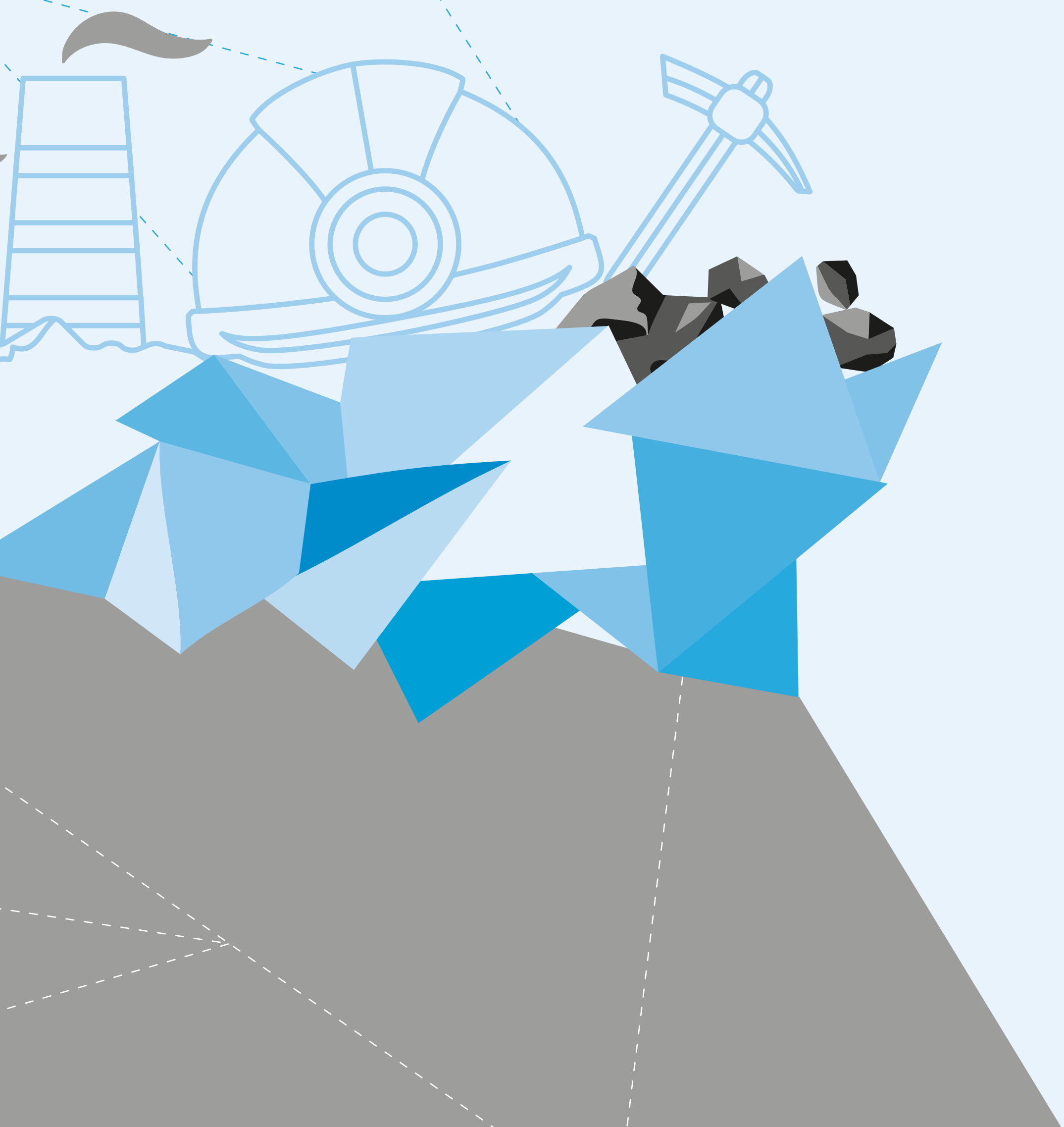
Mr. Wang is a Director with China Cinda (HK) Holdings Company Limited ("Cinda HK"), the intermediate holding company of Novel Sunrise Investments Limited which is the Company's second largest shareholder. Prior to joining China Cinda in 2014, Mr. Wang worked in the Investment Banking Department of Macquarie Capital (Hong Kong) Limited and gained extensive experience in cross border mergers and acquisitions transactions, valuation, due diligence and investment analysis.

Mr. Wang graduated from University of Sydney with a Master Degree of Economics in 2011 and a Bachelor Degree in Economics & Finance in 2010. Mr. Wang is a member of the Canadian Institute of Corporate Directors.


MT4400AC

STRATEGIC LOCATION

The Ovoot Tolgoi Mine is located approximately 40km from China, which represents the Company's main coal market. The Company has an infrastructure advantage, being approximately 50km from a major Chinese coal distribution terminal with rail connections to key coal markets in China.



DIRECTORS' REPORT

The board of directors (the "Directors" and the "Board", respectively) of SouthGobi Resources Ltd. ("SGQ") is pleased to present its report along with the audited consolidated financial statements (the "Financial Statements") of SGQ together with its subsidiaries (collectively the "Company") for the financial year ended December 31, 2016 (the "Financial Year").

Principal activities, business review and geographical analysis of operations

The Company is an integrated coal mining, development and exploration company. The Company's principal subsidiaries are set out in Note 29 to the Financial Statements and the activities of all subsidiaries of the Company at December 31, 2016 are set out in the table below:

Name	Country of incorporation	Issued ordinary/ registered share capital	Principal activities
SGQ Coal Investment Pte. Ltd	Singapore	US$1	Investment holding
SGQ Dayarcoal Mongolia Pte. Ltd	Singapore	US$1	Investment holding
Mazaatt Holdings Pte. Ltd.	Singapore	US$1	Investment holding
SouthGobi Sands LLC	Mongolia	MNT 248,953,000	Coal mining, development and exploration of properties in Mongolia
Mazaalai Resources LLC	Mongolia	MNT 1,000,000	Investment holding
Mazaatt Holdings LLC	Mongolia	MNT 248,953,000	Investment holding
Dayarbulag LLC	Mongolia	MNT 248,953,000	Investment holding
SouthGobi Resources (Hong Kong) Limited	Hong Kong	HK$1	Business services and investment holding
TST Holdings Limited	Hong Kong	HK$1	Investment holding
SouthGobi Trading (Beijing) Co., Ltd.	China	US$400,000	Coal trading
Inner Mongolia SouthGobi Energy Ltd.	China	CNY 100,000,000	Import agency and trading of coal

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 to the Financial Statements.

A review of the business of the Company during the Financial Year and a further discussion and analysis of these activities, including a description of the principal risks and uncertainties the Company may be facing and an indication of likely future development in the Company's business, can be found in Management Discussion and Analysis set out on pages 40 to 109 of this Annual Report. The discussion forms part of this directors' report.

Results

The results of the Company for the Financial Year are set out in the Consolidated Statement of Comprehensive Income on page 120 of this Annual Report.

Dividends

The Board does not recommend the payment of any final dividend for the Financial Year (2015: Nil). No interim dividend was declared or paid during the Financial Year (2015: Nil).

Property, plant and equipment

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

Share capital

Details of the movements in the share capital of the Company during the Financial Year are set out in Note 24 to the Financial Statements and in the Consolidated Statement of Changes in Equity on page 122 of this Annual Report.

The Company did not enter into any private placements for equity or debt securities during the Financial Year.

Neither the Company, nor any of its subsidiaries purchased, sold or redeemed any of the Company's listed securities during the Financial Year.

Reserves

Details of the reserves available for distribution to the shareholders of the Company (the "Shareholders") as at December 31, 2016 are set out in the Consolidated Statement of Changes in Equity on page 122 of this Annual Report.

Directors

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

Independent Non-Executive Directors (the "INEDs")

Current

Mr. Mao Sun *(Interim Lead Director)* (1)
Mr. Zhu Liu
Ms. Jin Lan Quan
Mr. Joseph Belan (6)

Prior

Mr. Pierre Lebel (8)

Executive Directors

Current

Mr. Ningqiao Li *(Executive Chairman)* (2)(5)
Mr. Aminbuhe (3)(5)
Mr. Yulan Guo (4)(5)

Non-Executive Director

Current

Mr. Huiyi Wang (7)

Notes:

1) Mr. Sun was appointed interim Lead Director of the Company on August 16, 2016;

2) Mr. Li is an Executive Director and the Executive Chairman of the Company;

3) Mr. Aminbuhe is an Executive Director and the Chief Executive Officer of the Company;

4) Mr. Guo is an Executive Director and the Chief Financial Officer of the Company;

5) Messrs. Aminbuhe, Li and Guo are directors of Voyage Wisdom Limited, a private company which owned a 9.99% interest in the Company as at December 31, 2016;

6) Mr. Belan joined the Board on August 16, 2016;

7) Mr. Wang joined the Board on February 18, 2016. Mr. Wang is an employee of China Cinda (HK) Holdings Company Limited, an intermediate holding company of Novel Sunrise Investments Limited ("Novel Sunrise"); and

8) Mr. Lebel retired as the Lead Director and an INED of the Company on June 30, 2016. He has confirmed that he has no disagreement with the Board and there is no matter relating to his retirement that needs to be brought to the attention of the Shareholders.

Except where such Director has already resigned from the Board, the term of office for each of the Directors will end at the conclusion of the forthcoming annual general meeting of the Company (the "2017 AGM"). In accordance with article 14.1 of the articles of continuation of the Company (the "Articles of Continuation"), all of the Directors, including the independent non-executive Directors and the non-executive Director, would retire and, being eligible, offer themselves for re-election at the 2017 AGM.

The Company has received written annual confirmations of independence from Messrs. Belan, Liu and Sun and Ms. Quan, all INEDs, and as at the date of this report still considers them to be independent in accordance with the applicable listing rules.

Directors' service contracts

None of the Directors proposed for re-election at the 2017 AGM 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 transactions, arrangements or contracts of significance

No transactions, arrangements or contracts of significance in relation to the Company's business to which the Company or any of its subsidiaries was a party and in which a Director or a connected entity of a Director had a material interest, whether directly or indirectly, subsisted at the end of the Financial Year 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 and the controlling Shareholders had any interests in businesses that compete or are likely to compete, either directly or indirectly, with the Company's business.

Directors' and chief executive's interests and short positions in shares, underlying shares and debentures

At December 31, 2016, or in the case of departed Director as at his resignation date, the interests of the Directors and chief executive of the Company in the shares, underlying shares and debentures of the Company and its associated corporations were as follows:

Interests in common shares of SGQ (the "Shares"):

	Number of Shares and underlying Shares held, capacity and nature of interest						
		Number of Shares interested			Number of underlying Shares interested		
Name of Directors	Directly beneficially owned	Through spouse or minor children	Through controlled company	Beneficiary of a trust	Directly beneficially owned	Total [6]	Approximate percentage of SGQ's issued Shares [5]
Current Directors							
Ningqiao Li	–	–	25,768,162 [1]	–	100,000 [4]	25,868,162	10.04%
Aminbuhe	–	–	25,768,162 [2]	–	100,000 [4]	25,868,162	10.04%
Yulan Guo	–	–	25,768,162 [3]	–	100,000 [4]	25,868,162	10.04%
Joseph Belan	–	–	–	–	250,000 [4]	250,000	0.10%
Zhu Liu	–	–	–	–	250,000 [4]	250,000	0.10%
Jin Lan Quan	–	–	–	–	250,000 [4]	250,000	0.10%
Mao Sun	–	–	–	–	300,000 [4]	300,000	0.12%
Former Director							
Pierre Lebel	5,100	–	–	–	297,352 [4]	302,452	0.13%

Notes:

(1) Mr. Li is a director of and owns 45% of Voyage Wisdom Limited, a private company which owned 9.99% interest in the Company as at December 31, 2016.

(2) Mr. Aminbuhe is a director of and owns 45% of Voyage Wisdom Limited, a private company which owned 9.99% interest in the Company as at December 31, 2016.

(3) Mr. Guo is a director of and owns 10% of Voyage Wisdom Limited, a private company which owned 9.99% interest in the Company as at December 31, 2016.

(4) These interests represented the underlying Shares comprised in the share options granted by the Company.

(5) The percentage represents the total number of the Shares and the underlying Shares interested divided by the number of issued Shares as at December 31, 2016 (i.e. 257,697,035 Shares).

(6) All interests stated are long positions.

Other than the shareholdings disclosed in the preceding tables, none of the Directors and the chief executive of the Company had any interests or short positions in any shares, underlying shares or debentures of the Company or any of its associated corporations as at December 31, 2016.

Share option plan

The particulars of the Company's share option plan (the "Share Option Plan") are set out in Note 25 to the Financial Statements. The following table discloses movements in the Company's share options for the Financial Year:

	Number of share options								
Name	At January 1, 2016	Granted during the Financial Year	Exercised during the Financial Year	Forfeited during the Financial Year	Expired during the Financial Year	At December 31, 2016	Date of grant	Exercise period	Exercise price per Share CAD$
Ningqiao Li	100,000	–	–	–	–	100,000	December 14, 2015	December 14, 2016 – December 14, 2019	0.29
	100,000	**–**	**–**	**–**	**–**	**100,000**			
Aminbuhe	100,000	–	–	–	–	100,000	December 14, 2015	December 14, 2016 – December 14, 2019	0.29
	100,000	**–**	**–**	**–**	**–**	**100,000**			
Yulan Guo	100,000	–	–	–	–	100,000	December 14, 2015	December 14, 2016 – December 14, 2019	0.29
	100,000	**–**	**–**	**–**	**–**	**100,000**			
Joseph Belan	–	100,000	–	–	–	100,000	August 26, 2016	August 31, 2017 – August 31, 2021	0.25
	–	75,000	–	–	–	75,000	November 16, 2016	November 16, 2017 – November 16, 2021	0.33
	–	75,000	–	–	–	75,000	November 16, 2016	November 16, 2018 – November 16, 2021	0.33
	–	**250,000**	**–**	**–**	**–**	**250,000**			
Zhu Liu	100,000	–	–	–	–	100,000	December 14, 2015	December 14, 2016 – December 14, 2019	0.29
	–	75,000	–	–	–	75,000	November 16, 2016	November 16, 2017 – November 16, 2021	0.33
	–	75,000	–	–	–	75,000	November 16, 2016	November 16, 2018 – November 16, 2021	0.33
	100,000	**150,000**	**–**	**–**	**–**	**250,000**			
Jin Lan Quan	100,000	–	–	–	–	100,000	December 14, 2015	December 14, 2016 – December 14, 2019	0.29
	–	75,000	–	–	–	75,000	November 16, 2016	November 16, 2017 – November 16, 2021	0.33
	–	75,000	–	–	–	75,000	November 16, 2016	November 16, 2018 – November 16, 2021	0.33
	100,000	**150,000**	**–**	**–**	**–**	**250,000**			
Mao Sun	100,000	–	–	–	–	100,000	December 14, 2015	December 14, 2016 – December 14, 2019	0.29
	–	100,000	–	–	–	100,000	November 16, 2016	November 16, 2017 – November 16, 2021	0.33
	–	100,000	–	–	–	100,000	November 16, 2016	November 16, 2018 – November 16, 2021	0.33
	100,000	**200,000**	**–**	**–**	**–**	**300,000**			
Pierre Lebel	40,000	–	–	–	(40,000)	–	August 15, 2011	August 15, 2012 – August 15, 2016	9.43
	20,000	–	–	–	–	20,000	March 21, 2012	March 21, 2013 – March 21, 2017	6.16
	20,000	–	–	–	–	20,000	December 6, 2012	December 6, 2013 – December 6, 2017	1.92
	257,352	–	–	–	–	257,352	August 13, 2014	August 13, 2015 – August 13, 2019	0.58
	337,352	**–**	**–**	**–**	**(40,000)**	**297,352**			
Total for Directors	**937,352**	**750,000**	**–**	**–**	**(40,000)**	**1,647,352**			
Other share option holders	115,000	–	–	–	(115,000)	–	August 15, 2011	August 15, 2012 – August 15, 2016	9.43
	69,500	–	–	–	(37,500)	32,000	March 21, 2012	March 21, 2013 – March 21, 2017	6.16
	70,000	–	–	(23,800)	(46,200)	–	August 13, 2013	August 14, 2014 – August 13, 2019	1.16
	92,000	–	–	–	(57,500)	34,500	December 6, 2012	December 6, 2013 – December 6, 2017	1.92
	32,847	–	–	(8,147)	(15,815)	8,885	March 26, 2014	March 26, 2015 – March 26, 2019	0.65
	670,876	–	–	(82,782)	(563,960)	24,134	August 13, 2014	August 13, 2015 – August 13, 2019	0.58
	411,020	–	–	(209,488)	(38,476)	163,056	April 1, 2015	April 1, 2016 – April 1, 2020	0.92
Total for other share option holders	1,461,243	–	–	(324,217)	(874,451)	262,575			
TOTAL	**2,398,595**	**750,000**	**–**	**(324,217)**	**(914,451)**	**1,909,927**			

Details of the accounting policy for the Share Option Plan are set out in Note 3.11 to the Financial Statements.

Arrangement to purchase shares and debentures

Eligible Directors, employees and members of management are able to participate in the Company's share purchase plan (the "Share Purchase Plan"), which allows participants to contribute up to 7% of their basic annual salary to purchase shares in the Company. The Company contributes 50% of the participant's contribution and at the end of each calendar quarter, Shares are issued by the Company on behalf of the participants.

Substantial shareholders

The register of interests and short positions in Shares required to be kept by the Company (the "Register of Interests") showed that as at December 31, 2016, the Company has been notified of the following interests in the Shares and underlying Shares (other than those of a Director of the chief executive of the Company) representing 5% or more of the Company's issued Shares:

Name of substantial shareholders	Nature of interest	Number of Shares held [(a)]	Approximate percentage of issued Shares [(e)]
Novel Sunrise [(b)]	Beneficial	46,358,978	17.99%
Hope Rosy Limited [(b)]	Interest of a controlled corporation	46,358,978	17.99%
China Cinda (HK) Investments Management Company Limited [(b)]	Interest of controlled corporations	46,358,978	17.99%
China Cinda (HK) Holdings Company Limited [(b)]	Interest of controlled corporations	46,358,978	17.99%
China Cinda Asset Management Co., Limited [(b)]	Interest of controlled corporations	46,358,978	17.99%
The Ministry of Finance of the People's Republic of China ("MOF") [(b)]	Interest of controlled corporations	46,358,978	17.99%
Land Breeze II S.a.r.l. [(c)]	Beneficial	49,875,030	19.35%
Fullbloom Investment Corporation [(c)]	Interest of a controlled corporation	49,875,030	19.35%
China Investment Corporation ("CIC") [(c)]	Interest of controlled corporations	49,875,030	19.35%
Voyage Wisdom Limited [(d)]	Beneficial	25,768,162	9.99%
China Wish Group Limited	Beneficial	15,000,013	5.82%

Notes:

(a) The information as to the Shares beneficially owned or controlled or directed that is not within the knowledge of the Company, its Directors or its officers has been furnished by the applicable Shareholders or has been extracted from the public filings.

(b) Novel Sunrise is a wholly-owned subsidiary of Hope Rosy Limited, which is a wholly-owned subsidiary of China Cinda (HK) Investments Management Company Limited. China Cinda (HK) Investments Management Company Limited is a wholly-owned subsidiary of China Cinda (HK) Holdings Company Limited, which is wholly owned by China Cinda Asset Management Co., Limited. China Cinda Asset Management Co., Limited is indirectly controlled by MOF. Accordingly, each of Hope Rosy Limited, China Cinda (HK) Investments Management Company Limited, China Cinda (HK) Holdings Company Limited, China Cinda Asset Management Co., Ltd and MOF was deemed to be interested in Shares held by Novel Sunrise.

(c) Land Breeze II S.a.r.l. is a wholly-owned subsidiary of Fullbloom Investment Corporation, which is wholly owned by CIC. Accordingly, each of Fullbloom Investment Corporation and CIC was deemed to be interested in Shares held by Land Breeze II S.a.r.l.

(d) Messrs. Aminbuhe, Li and Guo are directors of Voyage Wisdom Limited, a private company which owned 9.99% interest in the Company as at December 31, 2016.

(e) The percentage represents the total number of the Shares and the underlying Shares interested divided by the number of issued Shares as at December 31, 2016 (i.e. 257,697,035 Shares).

(f) All interests stated above are long positions.

Other than as disclosed above, according to the Register of Interests, the Company has not been notified of any relevant interests or short positions in the Shares and underlying Shares as at December 31, 2016.

Management contracts

No contracts concerning the management and administration of the whole or any substantial part of the Company's business were entered into or existed during the Financial Year.

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 is administered by the Compensation and Benefits Committee and approved by the Board, having regard to comparable market statistics.

The Company has also adopted an equity incentive plan to incentivize Directors and eligible employees. Details of the plan are set out in Note 25 to the Financial Statements.

Details of the emoluments of the Directors and five individuals with the highest emoluments for the Financial year are set out in Appendix A1 to the Financial Statements.

Pre-emptive rights

There are no provisions for pre-emptive rights under the 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

Pursuant to the rules and regulations of the Toronto Stock Exchange, a company's securities may be delisted if the number of freely-tradable, publicly held securities is less than 500,000 or the number of public security holders, each holding a board lot consisting of 100 common shares or more, is less than 150. 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 19% of the Company's purchases.

The five largest suppliers accounted for 61% of the Company's purchases in aggregate.

Sales

The largest customer accounted for 67% of the Company's sales.

The five largest customers accounted for 91% of the Company's sales in aggregate.

At no time during the Financial Year did a Director, a close associate (as defined in the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules")) of a Director or a Shareholder (which to the knowledge of the Directors owns more than 5% of the Company's share capital) had 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$78,523 (2015: US$37,871).

Permitted Indemnities

The Company has arranged for appropriate insurance cover for the Directors' and Officers' liabilities in respect of legal actions against the Directors and senior management of the Company arising out of corporate activities.

Pursuant to the Articles of Continuation and subject to the Business Corporations Act of British Columbia, Canada, the Company must indemnify a director or former director of the Company and his or her heirs and legal personal representatives against all eligible penalties to which such person is or may be liable, and the Company must, after the final disposition of an eligible proceeding, pay the expenses actually and reasonably incurred by such person in respect of that proceeding.

Related party transactions

Related party transactions of the Company during the Financial Year are disclosed in Note 29 to the Financial Statements. They did not constitute connected transactions or continuing connected transactions, which are required to comply with the disclosure requirements in accordance with Chapter 14A of the Listing Rules.

Equity-linked agreements

Other than the Share Option Plan and the Share Purchase Plan as disclosed above and the section headed Management's Discussion and Analysis – Liquidity and Capital Resources – CIC Convertible Debenture, no equity-linked agreements that (i) will or may result in the Company issuing Shares or (ii) require the Company to enter into any agreements that will or may result in the Company issuing Shares were entered into by the Company during the Financial Year or subsisted at the end of the Financial Year.

Tax relief

The Company is not aware of any relief on taxation available to the Shareholders by reason of their holdings of the Shares. If the Shareholders are unsure about the taxation implications of purchasing, holding, disposing of, dealing in, or exercising of any rights in relation to the Shares, they are advised to consult their professional advisers.

Independent auditor

A resolution will be submitted at the 2017 AGM to re-appoint PricewaterhouseCoopers LLP as independent auditors of the Company.

On behalf of the Board

Ningqiao Li
Executive Chairman of the Board and
Executive Director
March 31, 2017

CORPORATE GOVERNANCE REPORT

Corporate Governance

The board of directors of the Company (the "Directors" and the "Board", respectively) considers good corporate governance practices to be an important factor in the continued and long-term success of the Company by helping to maximize shareholder value over time.

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

- Approved, adopted and reviewed a mandate for the Board, which sets out its stewardship responsibilities;
- appointed an independent non-executive Director, as "Lead Director" (the "Lead Director"), with the specific responsibility of, among other things, maintaining the independence of the Board and ensuring that the Board carries out its responsibilities mandated by applicable statutory and regulatory requirements and stock exchange listing standards;
- appointed an Audit Committee (composed of independent non-executive Directors), a Nominating and Corporate Governance Committee (composed of independent non-executive Directors), a Compensation and Benefits Committee (composed of independent non-executive Directors) and a Health, Environment, Safety and Social Responsibility ("HESS") Committee (composed of independent non-executive and executive Directors);
- approved charters for Board committees, including the Audit, Nominating and Corporate Governance, Compensation and Benefits, and Health, Environment, Safety and Social Responsibility Committees;
- established a Disclosure Committee for the Company, comprised of members of management and the Chair of the Nominating and Corporate Governance Committee, with the mandate to oversee the Company's disclosure practices;
- reviewed and updated the Company's Corporate Disclosure, Confidentiality and Securities Trading Policy and its Disclosure Controls and Procedures;
- established an independent Strategic Advisory Board to provide non-binding strategic guidance and advice to the Board in connection with the Company's ongoing business activities and initiatives and appointed its initial member;
- adopted formalized written position descriptions for the Executive Chairman, Lead Director, Chief Executive Officer (the "CEO") and Chief Financial Officer (the "CFO"), as well as the Chairs of the Audit, Nominating and Corporate Governance, Compensation and Benefits and Health, Environment, Safety and Social Responsibility Committees clearly defining their respective roles and responsibilities;
- adopted and implemented a compliance program for all Directors and employees, including business integrity policies and the EthicsPoint whistleblowing program;
- adopted and implemented a Board Diversity Policy (as defined below);
- 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;
- participated in a seminar conducted by the Company's external legal counsel which provided an overview of rules and regulations and detailed the Company's multi-jurisdictional obligations; and
- commissioned reports from an independent third party on compensation for the Company's executive management and independent non-executive Directors.

Compliance with Corporate Governance

Throughout the year ended December 31, 2016 (the "Financial Year"), the Company has 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, save as disclosed in this report. The Company's current practices are reviewed and updated regularly to ensure that the latest developments in corporate governance are followed and observed.

In December 2012, the Company approved the adoption and implementation of a new compliance program. Throughout 2013 and 2014, additional Business Integrity standards were adopted, including Anti-bribery, Anti-corruption, Dawn Raid Guidelines, Conflict of Interest Policies and Guidelines for the investigation into allegations of serious wrongdoing (collectively, the "Code of Conduct Standards"), and the EthicsPoint whistleblowing program.

The Code of Conduct Standards provides that the Company's employees, consultants, officers and Directors will uphold its commitment to a culture of honesty, integrity and accountability and that the Company requires the highest standards of professional and ethical conduct from its employees, consultants, officers and Directors. The various policies forming the Code of Conduct Standards are available on the Company's website (www.southgobi.com) and a copy of the Code of Conduct Standards may be obtained, without charge, by request to SouthGobi Resources Ltd., Suite 1100 – 355 Burrard Street, Vancouver, British Columbia, Canada V6C 2G8, Attention: Corporate Department, or by phone to 604-681-6799.

EthicsPoint is the Company's confidential whistleblowing program, which is administered by an independent third party, and is available for use when someone suspects or is aware of illegal, unsafe or inappropriate activity at work. EthicsPoint provides an avenue for individuals to raise concerns confidentially and anonymously.

The Audit Committee monitors compliance with the Code of Conduct Standards. 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.

Pursuant to code provision A.6.7 of the Corporate Governance Code (the "Corporate Governance Code") contained in Appendix 14 to the Rules Governing the Listing of Securities on the Hong Kong Stock Exchange (the "Hong Kong Listing Rules"), the independent non-executive directors and other non-executive directors should attend general meetings and develop a balanced understanding of the views of shareholders. Due to other engagements, certain independent non-executive Directors and the non-executive Director were unable to attend the annual general meeting on September 30, 2016 (the "Annual General Meeting").

Pursuant to code provision E.1.2 of the Corporate Governance Code, the chairman of the board of directors should attend the annual general meeting. However, Mr. Li, the Executive Chairman, was unable to attend the Annual General Meeting due to other significant business commitments. In the absence of the Executive Chairman, Mr. Sun, an independent non-executive Director and the Interim Lead Director, acted as chairman of the Annual General Meeting to ensure an effective communication with the shareholders of the Company (the "Shareholders"). Mr. Li had a follow-up with Mr. Sun in respect of the opinions expressed or concerns raised, if any, by the Shareholders at the Annual General Meeting.

Board Composition

In its corporate governance guidelines, the Canadian Securities Administrators (the "CSA") recommend that a majority of the directors of a corporation be independent directors. Under the CSA corporate governance guidelines, a director is independent if he or she has no direct or indirect material relationship with the Company. A "material relationship" is one which could, in the view of the Board, be reasonably expected to interfere with the exercise of the Director's independent judgment. The Company considers that a partner, shareholder or officer of an organization that has a material relationship with the Company has an indirect material relationship under the CSA corporate governance guidelines and is, therefore, not an independent Director.

Based on information regarding personal and business circumstances provided in a comprehensive questionnaire completed annually by each of the Directors and a reasonable enquiry of the Board to determine whether or not the members of the Board are independent, the Board is satisfied that four (4) of its eight (8) current members representing 50% of all Board members are independent.

CORPORATE GOVERNANCE REPORT

Although 50% of the Board members are not independent, five (5) of the eight (8) Directors are non-executive Directors. In the event that the Board must consider a potential or actual conflict, such matter is referred to the independent non-executive Directors to ensure that processes are in place to receive independent scrutiny. To facilitate the exercise of independent judgment, the independent and non-executive members of the Board meet regularly. In 2016, the independent non-executive Directors met four (4) times.

Independent Non-Executive Directors	Executive Directors
Current	**Current**
Mr. Mao Sun *(Interim Lead Director)* (1)	Mr. Ningqiao Li *(Executive Chairman)* (2)(5)
Mr. Zhu Liu	Mr. Aminbuhe (3)(5)
Ms. Jin Lan Quan	Mr. Yulan Guo (4)(5)
Mr. Joseph Belan (6)	
	Non-Executive Director
Prior	**Current**
Mr. Pierre Lebel (8)	Mr. Huiyi Wang (7)

Notes:
1) Mr. Sun was appointed interim Lead Director of the Company on August 16, 2016;
2) Mr. Li is an Executive Director and the Executive Chairman of the Company;
3) Mr. Aminbuhe is an Executive Director and the CEO of the Company;
4) Mr. Guo is an Executive Director and the CFO of the Company;
5) Messrs. Aminbuhe, Li and Guo are directors of Voyage Wisdom Limited, a private company which owned 9.99% interest in the Company as at December 31, 2016;
6) Mr. Belan joined the Board on August 16, 2016;
7) Mr. Wang joined the Board on February 18, 2016. Mr. Wang is an employee of China Cinda (HK) Holdings Company Limited ("Cinda HK"), an intermediate holding company of Novel Sunrise Investments Limited ("Novel Sunrise"); and
8) Mr. Lebel retired as a Director and the Lead Director on June 30, 2016.

As at March 31, 2017, Novel Sunrise, China Investment Corporation and Voyage Wisdom Limited held approximately 17.01%, 23.76% and 9.45% of the Company's issued and outstanding common shares, respectively.

The Board has determined that Messrs. Belan, Liu and Sun and Ms. Quan are independent Directors.

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 an Executive Chairman with extensive experience and knowledge of the Company's business.

The role of the Executive Chairman and the CEO are separate and exercised by different individuals. Mr. Li, the Executive Chairman of the Company, is responsible for chairing meetings of and facilitating the functions of the Board, while Mr. Aminbuhe, the CEO, is responsible for the Company's operations.

The Board has in place a Lead Director with the specific responsibility of maintaining the independence of the Board and ensuring that the Board carries out its responsibilities. Mr. Sun has served as the Company's interim Lead Director since August 2016. Mr. Sun does not serve in a similar capacity with any other company.

The Company has received from each of the independent non-executive Directors, his/her confirmation of independence pursuant to listing rules in all applicable jurisdictions. The Company considers four (4) of the five (5) non-executive Directors to be independent.

To the best knowledge of the Company, none of the Directors are related, except indirectly as noted below. Relationships include financial, business or family relationships. In this connection, the Company notes that Messrs. Aminbuhe, Guo and Li are directors of Voyage Wisdom Limited, a private company which owned 9.99% of the issued equity interest of the Company as at December 31, 2016. Additionally, Messrs. Guo and Li are former directors of Novel Sunrise, the Company's second largest shareholder (the "Shareholder(s)"), and Mr. Wang is a director of Cinda HK, the intermediate holding company of Novel Sunrise. Each Director is free to exercise his or her independent judgment.

Mandate of the Board (the "Board Mandate")

Under the British Columbia Business Corporations Act ("BCBCA"), the Directors 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 furthering 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 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, the Board retains a supervisory role in respect of, and the ultimate responsibility for, all matters relating to the Company and its business.

The Board 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 Shareholders' 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 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. At least one (1) Board meeting per year is devoted to a comprehensive review of strategic corporate plans proposed by management.

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 the Board's approval, on all ordinary course matters relating to the Company's business.

The Board 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 Shareholders' 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 reasonably sees fit. Any individual Director is entitled to engage an outside advisor at the expense of the Company provided that 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 annual basis.

The Company has a disclosure policy addressing, among other things, the procedures and internal controls for the handling and dissemination of inside information, how the Company interacts with analysts and the public, and contains measures for the Company to avoid selective disclosure. The terms of the disclosure policy are no less exacting than those set out in the Guidelines on Disclosure of Inside Information published by the Securities and Futures Commission of Hong Kong.

The Company has a Disclosure Committee, comprised of members of management and with participation by the Chair of the Nominating and Corporate Governance Committee. The Disclosure Committee is responsible for overseeing the Company's disclosure practices. The Disclosure Committee assesses materiality and determines when developments justify public disclosure. It also 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 the 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

The Board has established several Board committees, namely the Audit, Nominating and Corporate Governance, Compensation and Benefits, and HESS Committees, for overseeing particular aspects of the Company's affairs. All the said Committees have been established with defined written charters, which are published on the respective websites of the Company and The Stock Exchange of Hong Kong Limited (the "Hong Kong Stock Exchange"), and are available to the Shareholders upon request. All the Board committees should report to the Board on their decisions or recommendations made.

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. Belan, Liu and Sun and Ms. Quan. Mr. Sun is the Chair of the Audit Committee. Mr. Liu joined the Audit Committee on June 30, 2016 and Mr. Belan joined the Audit Committee on August 16, 2016. Mr. Lebel ceased to be a member of the Audit Committee on June 30, 2016.

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 Audit Committee has the powers and responsibilities set forth in its charter, the role of the committee is oversight. Annually, the Board reviews the Committee's charters and the Board Mandate. In 2017, the Board will review the current charters and update to incorporate the specifications mentioned by the Corporate Governance Code. The members of the Audit 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 a capacity. Consequently, it is not the duty of the Audit 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 Auditor must be approved in advance by the Audit Committee or a designated member of the Audit Committee (a "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 the 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 of the service. 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 are pre-approved by the Audit Committee or the Designated Member and then be recommended to the Board for approval or ratification.

The Audit Committee held four (4) 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 Auditors;
- reviewed the quarterly, 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 Audit 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 members of the Board and the committees of the Board 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.

CORPORATE GOVERNANCE REPORT

The members of the Nominating and Corporate Governance Committee are Messrs. Belan, Liu and Sun and Ms. Quan. Mr. Belan was appointed as the Chair of the Nominating and Corporate Governance Committee on November 8, 2016 and joined the Nominating and Corporate Governance Committee on August 16, 2016. Mr. Sun was interim Chair of the Nominating and Corporate Governance Committee from June 30, 2016 to November 8, 2016. Mr. Lebel ceased to be a member of the Nominating and Corporate Governance Committee on June 30, 2016.

During the course of 2016, the Nominating and Corporate Governance Committee met three (3) times. In performing its duties in accordance with the Nominating and Corporate Governance Committee's charter, the Nominating and Corporate Governance Committee has:

- reviewed the Nominating and Corporate Governance Committee's charter to ensure that the Company has the appropriate procedures and processes in place to facilitate the nomination of Directors;
- conducted self-assessments of the Board and the Board committees;
- reviewed the structure, size and composition (including the skills, knowledge and experience) of the Board;
- made recommendations to the Board on the selection of individuals nominated for directorship in view of their qualifications and related expertise;
- made recommendations to the Board on the selection of individuals nominated for senior management roles;
- evaluated the Company's executive management succession plans;
- ensured that the Board has the necessary structures and procedures so that it can function with an appropriate degree of independence from management;
- provided a forum without management present to receive expressions of concern, including any concern regarding matters involving the independence of the Board from management;
- conducted induction programs for new Directors;
- recommended the establishment of an independent Strategic Advisory Board and the appointment of its initial member; and
- reviewed the practices and procedures of the Board in light of ongoing developments in regulatory and stock exchange requirements and industry best practices in matters of corporate governance and recommended to the Board any changes considered necessary or desirable; and
- assessed the independence of independent non-executive Directors and reviewed the continuing professional development of the Directors as required by the Corporate Governance Code.

Compensation and Benefits Committee

The Board has established a Compensation and Benefits Committee which operates under a charter approved by the Board. Annually, the Board reviews the Committee's charter and the Board Mandate. In 2017, the Board will review the current charter and update to incorporate the specifications mentioned by the Corporate Governance Code. 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 Equity Incentive Plan ("EIP"), determining the recipients as well as 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. Belan, Liu and Sun and Ms. Quan. Mr. Liu is the Chair of the Compensation and Benefits Committee. Ms. Quan joined the Compensation and Benefits Committee on June 30, 2016 and Mr. Belan joined the Compensation and Benefits Committee on August 16, 2016. Mr. Lebel ceased to be a member of the Compensation and Benefits Committee on June 30, 2016.

During the course of 2016, the Compensation and Benefits Committee met twice. In performing its duties in accordance with the Compensation and Benefits Committee's charter, the Compensation and Benefits Committee has:

- engaged Roger Gurr & Associates, a professional compensation and benefits consultancy firm, to conduct reviews of compensation programs for the Company's independent non-executive Directors and executive management;
- reviewed and made recommendations to the Board with respect to the adequacy and form of compensation and benefits of all executive officers and Directors;
- administered and made recommendations to the Board with respect to the Company's incentive compensation plans and equity-based plans;
- reviewed and approved corporate goals and objectives for the compensation of the CEO and the CFO, evaluating their performance and setting their compensation levels;
- recommended to the Board the performance evaluation of the CEO and the CFO, taking into consideration their annual objectives and performance; and
- determined the recipients as well as the nature and size of share compensation awards and bonuses granted from time to time.

Health, Environment, Safety and Social Responsibility Committee

The Board has established a Health, Environment, Safety and Social Responsibility Committee ("HESS"). 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 HESS Committee also reviews any incidents that occur and provides guidance on how to prevent any recurrences.

During the course of 2016, the HESS Committee met three (3) times, with two (2) of the meetings being held at the Ovoot Tolgoi mine site in South Gobi province, Mongolia. The members of the HESS Committee are Messrs. Aminbuhe, Guo and Liu. Mr. Aminbuhe is the Chair of the HESS Committee.

Mergers and Acquisitions Committee

The Board established a Mergers and Acquisitions ("M&A") Committee in 2010. 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. As a result of the independent non-executive Directors overseeing the Company's interests in potential future merger and acquisition transactions, the M&A Committee is inactive at this time and did not meet in 2016.

Ad Hoc/Special Committees

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

In 2014, a Special Committee composed of the Company's independent non-executive Directors was formed to oversee the Company's interests in proposed transactions between Turquoise Hill and interested parties. Turquoise Hill ceased to be a Shareholder in 2016 and the Special Committee did not meet during the Financial Year.

Through its Audit Committee (comprised solely of independent non-executive Directors), the Company conducted an internal investigation into possible breaches of law, internal corporate policies and codes of conduct arising from allegations raised in the context of investigations by Mongolian authorities. The Audit Committee had the assistance of independent legal counsel in connection with its investigation.

The former Chair of the Audit Committee also participated in a tripartite committee, comprised of the Audit Committee Chairs of the Company and Turquoise Hill and a representative of Rio Tinto, focused on the investigation of a number of those allegations, including possible violations of anti-corruption laws. Independent legal counsel and forensic accountants assisted this committee with its investigation. The tripartite committee substantially completed the investigative stage of its activities during the third quarter of 2013. The Company continued to cooperate with the Mongolian authorities and the Canadian and American government and regulatory authorities that were monitoring the Mongolian investigations. It is possible that these authorities may subsequently conduct their own review or investigation or seek further information from the Company. Pending further reviews or questions from any of such government or regulatory authorities, the tripartite committee was stood down and investigations were paused. There have been no significant developments in respect of the internal investigations since the completion of the investigation phase during the third quarter of 2013.

The Company, through its Board and management, has taken a number of steps to address issues noted during the investigations and to focus ongoing compliance by all employees with all applicable laws, internal corporate policies and codes of conduct, and with the Company's disclosure controls and procedures and internal controls over financial reporting.

Following the conclusion of the internal investigations, the need for the tripartite committee was suspended pending further review or questions from any relevant regulatory authority.

Although there has been no standalone meeting being held between the Executive Chairman with the non-executive Directors and without the executive Directors present during the Financial Year, a chance for such communication channel is always offered at the end of the Board meetings. A meeting between the Executive Chairman and non-executive Directors will be scheduled for 2017 and annually going forward.

Strategic Advisory Board

In 2016, an independent Strategic Advisory Board was established to provide non-binding strategic guidance and advice to the Board in connection with the Company's ongoing business activities and initiatives. The Strategic Advisory Board is intended to consist of one or more members as determined by the Board, which will seek to select individuals based on their special knowledge, expertise and experience with companies in the Company's industry and/or area of operations, who are capable of making a valuable contribution to the Company's business. Members of the Strategic Advisory Board shall be independent from any affiliation, business relationship or transaction with the Company and its affiliates. In selecting members of the Strategic Advisory Board, preference will be given to individuals whose knowledge, expertise and experience has been gained as directors or officers of companies whose shares are listed on a major stock exchange. It will have no authority to make business decisions for the Company. The Strategic Advisory Board will have no governance role in respect of the Company and none of its members are to be considered to be Directors or officers of the Company or to have any of the responsibilities of a Director or an officer of the Company.

Mr. Braam Jonker, a business executive resident in Vancouver, Canada, with more than 20 years of management, accounting and corporate finance experience, principally in the mining industry, was appointed as the initial member of the Strategic Advisory Board in September 2016.

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 independent non-executive Directors also have the opportunity to meet separate from management. If required, between regularly scheduled Board meetings, a meeting of independent non-executive 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, there were: six (6) meetings of the Board, of which two (2) were held in Mongolia, four (4) meetings of the Audit Committee, three (3) meetings of the Nominating and Corporate Governance Committee, two (2) meetings of the Compensation and Benefits Committee and three (3) meetings of the HESS Committee. The Mergers and Acquisitions Committee was inactive in 2016 and no meetings were held. Attendance by the Directors at general meeting as well as Board and Board committee meetings held in the Financial Year is shown below:

Attendance record for the Annual General Meeting and Board and Board Committee meetings during the Financial Year [1]	Annual General Meeting	Board meetings	Audit Committee meetings	Nominating and Corporate Governance Committee meetings	Compensation and Benefits Committee meetings	HESS Committee meetings
	(Number of Attendances/Number of Meetings)					
Executive Directors						
Mr. Ningqiao Li *(Executive Chairman)*	0/1	6/6	N/A	N/A	N/A	N/A
Mr. Aminbuhe	0/1	6/6	N/A	N/A	N/A	3/3
Mr. Yulan Guo	0/1	6/6	N/A	N/A	N/A	3/3
Independent Non-Executive Directors						
Mr. Mao Sun *(Interim Lead Director)*	1/1	6/6	4/4	2/2[2]	2/2	N/A
Mr. Zhu Liu	0/1	6/6	2/2[3]	1/3	0/2	3/3
Ms. Jin Lan Quan	0/1	5/6	3/4	3/3	2/2[4]	N/A
Mr. Joseph Belan	0/1	2/2[5]	1/1[6]	1/1[7]	1/1[8]	N/A
Mr. Pierre Lebel [9]	N/A	3/3	2/2	1/1	N/A	N/A
Non-Executive Director						
Mr. Huiyi Wang	0/1	5/5[10]	N/A	N/A	N/A	N/A

Notes:

1) The Mergers and Acquisitions Committee is inactive and no meetings were held in 2016.
2) Mr. Sun joined the Nominating and Corporate Governance Committee on February 23, 2016 and there were two (2) meetings of the Nominating and Corporate Governance Committee following that date.
3) Mr. Liu joined the Audit Committee on June 30, 2016 and there were two (2) meetings of the Audit Committee following that date.
4) Ms. Quan joined the Compensation and Benefits Committee on June 30, 2016 and there were two (2) meetings of the Compensation and Benefits Committee following that date.
5) Mr. Belan joined the Board on August 16, 2016 and there were two (2) meetings of the Board following that date.
6) Mr. Belan joined the Audit Committee on August 16, 2016 and there was one (1) meeting of the Audit Committee following that date.
7) Mr. Belan joined the Nominating and Corporate Governance Committee on August 16, 2016 and there was one (1) meeting of the Nominating and Corporate Governance Committee following that date.
8) Mr. Belan joined the Compensation and Benefits Committee on August 16, 2016 and there was one (1) meeting of the Compensation and Benefits Committee following that date.
9) Mr. Lebel retired as a Director and ceased to be a member of any Board committees on June 30, 2016.
10) Mr. Wang joined the Board on February 18, 2016 and there were five (5) meetings of the Board following that date.

The Annual General Meeting was held in Vancouver, Canada on September 30, 2016 and attended by Mr. Sun.

Professional Development

The Company takes steps to ensure that prospective Directors fully understand the role of the Board and its Committees and the contribution of individual Directors are expected to make, including, in particular, the commitment of time and energy that the Company expects. New Directors are provided with a director orientation and are also briefed by management as to the status of the Company's business and are encouraged to visit the Company's properties and sites.

In addition, all Directors received a comprehensive briefing on the duties, responsibilities and liabilities of Directors, including the statutory duty of Directors to act honestly and in good faith with a view to the best interests of the Company when exercising the powers and performing the functions of Directors. In particular, the briefings focused on the Directors' obligations to provide objective oversight of the Company on behalf of all Shareholders notwithstanding other prior or current relationships.

Management and outside advisors provide information and education sessions to the Board and its committees as necessary to keep the Directors up-to-date with the Company, its business and the environment in which it operates as well as with developments in the responsibilities of directors. Presentations are made to the Directors from time to time to educate and keep them informed of changes within the Company and of regulatory and industry requirements and standards.

In May 2016, the Company's external legal counsel conducted a Directors' information session (the "Information Session") detailing the Company's multi-jurisdictional obligations including such matters as (i) Canadian rules and regulations under Corporate and Securities laws, (ii) Corporate Governance Code obligations, (iii) Toronto Stock Exchange and Hong Kong Stock Exchange obligations, (iv) Canadian regulatory oversight of emerging market issuers and (v) current issues in Canadian public company regulation. The Information Session was attended by Ms. Quan and Messrs. Aminbuhe, Guo, Li, Liu, Sun and Wang.

As a means of facilitating continuing education opportunities for Directors, all Directors are members of the Canadian Institute of Corporate Directors (the "ICD") and have the opportunity to attend courses relevant to the Company and its business, particularly with respect to corporate governance and the mining industry, at the Company's expense. Through the ICD, the Directors receive regular updates on numerous matters including: Board performance, governance and best practices.

In 2016, in addition to the Information Session, Messrs. Aminbuhe, Guo, Li, Liu and Wang continued their professional development by reading materials on directors' roles and functions and corporate governance practices. Mr. Belan continued his professional development by reading materials on directors' roles and functions and corporate governance practices.

In 2016, Mr. Sun attended the Emerging and Evolving Audit Committee Issues seminar, hosted by the ICD and participated in a variety of courses related to the accounting profession including: Canadian Public Company Financial Reporting Update – Q4 2016, Taxation Considerations for Estates and Trusts, 2016 Update on Taxation, 2016 Scientific Research & Experimental Development – Tax Blended and Taxation of Domestic Family Trusts – Advanced.

Throughout 2016, Ms. Quan participated in a range of courses offered by the ICD. She completed her professional development through the CPD Direct program designed by the Association of Chartered Accountants in Australia and the UK.

Ethical Business Conduct

Throughout the Financial Year, the Company has 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.

In 2012, the Company adopted and implemented a revised Code of Business Conduct and Ethics (the "Ethics Policy") called "*The Way We Work*". The Ethics Policy is applicable to all employees, consultants, officers and Directors regardless of their position in the organization, at all times and everywhere the Company does business.

In addition to "*The Way We Work*", the Company has also adopted additional guidance notes and standards which form part of the Company's overall Ethics Policy. The guidance notes and standards adopted include: guidelines for investigations into allegations of serious wrongdoing, dawn raid guidance notes, anti-bribery due diligence guidelines, business integrity standards relating to anti-corruption and conflicts of interest which make-up the Code of Conduct Standard, and the EthicsPoint program.

EthicsPoint is the Company's whistleblowing service hosted by an independent third party provider. EthicsPoint provides an avenue for employees to raise concerns confidentially and anonymously and it is available for use whenever someone suspects or is aware of illegal, unsafe or inappropriate activity at work. Information regarding EthicsPoint is available on the Company's website (www.southgobi.com).

The Ethics Policy and the Code of Conduct Standards provide that the Company's employees, consultants, officers and Directors will uphold its commitment to a culture of honesty, integrity and accountability and that the Company requires the highest standards of professional and ethical conduct from its employees, consultants, officers and Directors. A copy of the Ethics Policy entitled "*The Way We Work*" and the various policies forming the Code of Conduct Standards are available on the Company's website (www.southgobi.com) and may be obtained, without charge, by request to SouthGobi Resources Ltd., 1100 – 355 Burrard Street, Vancouver, British Columbia, Canada V6C 2G8, Attention: Corporate Department, or by phone to 604-681-6799.

The Audit Committee monitors compliance with the Code of Conduct Standards. The Nominating and 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.

Board Diversity Policy

The Company believes that a diverse board will enhance the decision making of the Board by utilizing the difference in skills, experience and background, geographical and industry experience, ethnicity, gender, knowledge and length of services, and other distinguishing qualities of the members of the Board. In support of this belief, the Board adopted a Board Diversity Policy in March 2014. All Board appointments will continue to be based on merit, having due regard to the overall effectiveness of the Board and diversity will be one of the criteria considered in determining the optimum composition of the Board.

In accordance with the Board Diversity Policy, Ms. Jin Lan Quan joined the Board as of August 6, 2015, the Audit Committee on September 1, 2015, the Nominating and Corporate Governance Committee on December 15, 2015, and the Compensation and Benefits Committee on June 30, 2016. Ms. Quan has extensive experience in financial consulting services with specialist skills in external auditing, internal audit structuring, corporate financing, risk management and business acquisition.

The Board currently consists of seven (7) men and one (1) woman, Ms. Quan, represents 12.5% of the total number of Directors.

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 has 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 business exposure, leading growth-orientated companies, mining exploration, diversity, financial literacy, legal knowledge, corporate governance, etc. The Nominating and Corporate Governance Committee annually assesses the current competencies and skill-sets 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 the 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 Director ends at the conclusion of the next Annual General Meeting following his or her most recent election or appointment.

CORPORATE GOVERNANCE REPORT

At every Annual General Meeting, the Shareholders entitled to attend and vote at the Annual General Meeting for the election of Directors have the rights to elect a Board consisting of the number of Directors for the time being set under the articles of continuation for the Company (the "Articles") 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, 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.

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 for Securities Transactions by Directors of Listed Issuers, Appendix 10 to the Hong Kong Listing Rules. The Company receives confirmation that the Directors have received, reviewed and agreed to abide by the terms of the Corporate Disclosure, Confidentiality and Securities Trading Policy.

Furthermore, if a Director (a) enters into a transaction involving securities 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 System for Electronic Disclosure by Insiders (SEDI) website (Sedi.ca) operated by the Ontario Securities Commission and a Form 3A is filed with the Hong Kong Stock Exchange.

A "related financial instrument" is defined as: (a) an instrument, agreement, security or exchange contract, the value, market price or payment obligations of which is/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.

Until August 17, 2016, the annual retainer for each of the non-executive Directors was fixed at:

	CAD$
Lead Director	60,000
Audit Committee Chair	40,000
Nominating and Corporate Governance Committee Chair	25,000
Compensation and Benefits Committee Chair	25,000
HESS Committee Chair	25,000

Should the HESS Committee be chaired by a non-executive Director, he or she would be entitled to receive the CAD$25,000 annual retainer.

Until August 17, 2016, each non-executive Director received a fee of CAD$1,500 for each Board meeting and each Committee meeting attended in person and CAD$600 for each conference call meeting in which they participated. Directors also receive a travel allowance of CAD$2,000 per round-trip in excess of four (4) hours' travel time.

In 2016, the Compensation and Benefits Committee retained Roger Gurr & Associates to conduct an in-depth review of the Company's compensation program for independent non-executive Directors. Following receipt of the report (the "Roger Gurr Report"), the Compensation and Benefits Committee recommended that effective August 17, 2016, the annual retainer for each of the independent non-executive Directors be adjusted as follows:

	CAD$
Independent Directors:	45,000
Audit Committee Chair:	20,000
Nominating and Corporate Governance Committee Chair:	20,000
Compensation and Benefits Committee Chair:	10,000
HESS Committee Chair:	10,000

Should the HESS Committee be chaired by an independent non-executive director, he or she would be entitled to receive the CAD$10,000 annual retainer.

The Committee deferred setting the annual retainer for the Lead Director until such time as the individual had been identified.

As recommended in the Roger Gurr Report, effective August 17, 2016, the meeting fees for each of the independent non-executive Directors was adjusted to CAD$1,500 for each Board meeting and each Committee meeting attended. Directors also continue to receive a travel allowance of CAD$2,000 per round-trip in excess of four (4) hours' travel time.

Upon joining the Board, Mr. Belan received 100,000 incentive stock options, which expire after in five (5) years, with a strike price of CAD$0.25 per share.

As recommended in the Roger Gurr Report, Messrs. Belan and Liu and Ms. Quan each received 150,000 incentive stock options, which expire after in five (5) years with a strike price of CAD$0.33 per share. In the capacity of the interim Lead Director, Mr. Sun received 200,000 incentive stock options, which expire after five (5) years with a strike price of CAD$0.33 per share.

All Directors are entitled to be reimbursed for actual expenses reasonably incurred in the performance of their duties as Directors.

Details regarding the remuneration of Directors are set out in Note A1 to the Financial Statements.

Risk Management and Internal Controls

The Board is responsible for maintaining appropriate and effective risk management and internal control systems. 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 policies and procedures of internal controls (which include financial, operational and compliance controls) are considered to be adequate and effective based on the annual review conducted by the Board through the Audit Committee.

The Company has conducted an annual review on whether there is a need for an internal audit department as there is no such department in the Company. Given the Company's relatively simple corporate and operation structure, as opposed to diverting resources to establish a separate internal audit department, the Board, supported by the Audit Committee, is directly responsible for risk management and internal control systems of the Company and for reviewing its effectiveness.

CORPORATE GOVERNANCE REPORT

In order to maintain a high standard of corporate governance, the Company engaged an external independent consultant with professional staff in possession of relevant expertise to conduct an independent review of the risk management and internal control systems of the Company during 2016. The review plan has been approved by the Board and the Audit Committee. The review includes a gap analysis of the current status of its risk management against the requirement of the Corporate Governance Code and Corporate Governance Report as well as internal audit procedures to evaluate the existence and effectiveness of key internal controls for certain key processes. Appropriate actions have been implemented accordingly to enhance the risk management and internal control systems. The improvement of the systems of risk management and internal control is an ongoing process and the Board maintains a continuing commitment to strengthen the Company's control environment and processes.

On an ongoing basis and annually, the Directors review the adequacy of the Company's resources, staff qualifications and experience, training programs and budget of the Company's accounting and financial reporting function. The Audit Committee reviewed the effectiveness of the Company's internal control policies as at December 31, 2016, and is of the view that the risk management and internal control systems in place are effective and adequate in safeguarding the investment of Shareholders and the assets of the Company.

Auditors

PricewaterhouseCoopers LLP is the Auditors of the Company and is independent within the meaning of the Rules of Professional Conduct of the Institute of Chartered Accountants of British Columbia, Canada. The financial reporting responsibilities and audit report of the independent auditors are set out on page 119 of this annual report.

PricewaterhouseCoopers LLP will be nominated at the upcoming Annual General Meeting for reappointment as Auditors at a remuneration to be fixed by the Board. PricewaterhouseCoopers LLP have served as the Auditors since April 3, 2012. Previously, the Auditors were Deloitte LLP.

Fees paid/payable to the external auditors, PricewaterhouseCoopers LLP and its affiliates in respect of audit and non-audit services provided during the Financial Year was approximately CAD$550,000.

These fees are detailed below:

Nature of services rendered	Fees paid/ payable (CAD$000's)
Audit fees [1]	451
Audit related fees	99
Tax fees	–
Other fees	–
Total	550

Notes:

1) Fees for audit services billed relating to fiscal 2016 consisted of: (i) audit of the Company's annual financial statements; (ii) review of the Company's quarterly financial statements; (iii) statutory audit of the annual financial statements of subsidiaries of the Company; and (iv) comfort letters, consents, and other services related to Canadian securities regulatory authorities' matters.

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 and financial reporting standards as well as statutory and regulatory requirements.

Going Concern

As at the date hereof, the Company has initiated a plan to change the existing product mix to higher value and higher margin outputs by washing certain grades of coal commencing in 2017 in order to produce more premium semi-soft coking coal and to initiate more processing of the lower grades of coal in order to reduce the ash content and improve the selling price and margins on its thermal coal product. The Company has also completed a new mine plan, which incorporates the coal washing and processing systems and contemplates significantly higher volumes of production in order to complement the Company's new product mix and sales volume targets. Such plans will involve the need for a significant level of stripping activities over the next two years and require certain capital expenditures to achieve the designed production outputs. Such expenditures will require the Company to seek additional financing in the form of finance leases, debt or equity. The Company has entered into an agreement for a finance lease on the new wash plant facility but will need financing to complete the thermal coal processing facilities.

There is no guarantee that the Company will be able to successfully secure additional sources of financing. This could result in adjustments to the amounts and classifications of assets and liabilities in the Company's consolidated financial statements and such adjustments could be material. Unless the Company acquires additional sources of financing and/or funding in the short term, the ability of the Company to continue as a going concern is threatened. If the Company is unable to continue as a going concern it may be forced to seek relief under applicable bankruptcy and insolvency legislation. Details are set out on page 124 and page 126 of this annual report.

Company Secretary

The Corporate Secretary of the Company is a member of each of the Canadian Institute of Corporate Directors and the Association of the Governance Professionals Canada (formerly the Canadian Society of Corporate Secretaries) and through these organizations, she has completed the on-going development during the Financial Year required under Rule 3.29 of the Hong Kong Listing Rules.

The Company has also appointed Mr. Siu Man Kwok as Hong Kong Company Secretary of the Company. He is a fellow member of each of the Institute of Chartered Secretaries and Administrators and the Institute of Financial Accountants in England, the Institute of Public Accountants in Australia, The Hong Kong Institute of Chartered Secretaries, The Association of Hong Kong Accountants and The Hong Kong Institute of Directors. As Mr. Kwok was first appointed as the company secretary of a Hong Kong Hang Seng Index constituent stock company in 1991 and has been acting in such capacity for a number of other reputable companies listed on the Hong Kong Stock Exchange at substantial times, he was not required to have at least 15 hours of relevant continuous professional development training for five consecutive years from 2012 (including the Financial Year). However, despite the above exemption, Mr. Kwok had delivered and attended over 15 hours' relevant seminars in the Financial Year under Rule 3.29 of the Hong Kong Listing Rules.

Mr. Kwok was nominated by Boardroom Corporate Services (HK) Limited ("Boardroom") to assume such office and Boardroom has been providing certain corporate secretarial services to the Company pursuant to an engagement letter entered into between the Company and Boardroom. The primary person at the Company with whom Mr. Kwok has been contacting in respect of company secretarial matters is Ms. Allison Snetsinger, The Company's Corporate Secretary.

Shareholders' Rights

Under Canadian corporate law, shareholders' rights are governed by the business corporation's legislation of the jurisdiction of incorporation of a company and by a company's constitutional documents. In the case of the Company, the BCBCA and the Articles govern the rights of Shareholders, as summarized in this section. The Board will consider the adoption of a shareholder policy in 2017 and in the interim, this section “Shareholders’ Rights” and the section below “Procedures by which enquiries may be put to the Board” do provide a basis for how Shareholders’ can communicate with the Company.

How Shareholders can convene an Extraordinary General Meeting

Shareholders may requisition a meeting for the purpose of transacting any business that may be transacted at a general meeting. The Shareholder or a group of Shareholders are required to hold (on the date of giving the requisition to the Company) an aggregate of at least 1/20 (five per cent (5%)) of the Company’s issued and outstanding common shares.

A valid requisition must:

- state the business to be transacted at the meeting (including the wording of any special resolution or exceptional resolution) in 1,000 words or less;
- be signed by and include the names and mailing addresses of all the requisitioning Shareholders;
- be made in a single record or several records, each of which is signed by one or more of the requisitioning Shareholders; and
- be delivered to the delivery address or mailed to the mailing address of the Company at its registered office.

The Company’s address for delivery is: SouthGobi Resources Ltd., Suite 1100-355 Burrard Street, Vancouver, British Columbia, Canada V6C 2G8, Attention: Corporate Department.

If the requisition consists of more than one record, the requisition is deemed to be received by the Company on the first date by which the Company received requisition records that comply with the above-listed conditions and by Shareholders holding the minimum number of shares to qualify for the requisition.

On receiving a valid requisition, the Board must call a general meeting to be held not more than four (4) months after the date on which the Company receives the requisition. The notice of the meeting and the information circular must include the date, time, location and text of the business to be approved. If the Board does not call a meeting within 21 days after the date of receiving the requisition, the requisitioning Shareholders or any one of them holding more than 1/40 (two and a half per cent (2.5%)) of the Company’s issued and outstanding common shares may send notice of a general meeting to transact the business stated in the requisition.

A general meeting called by the requisitioning Shareholders must be held within four months of the Company receiving the requisition notice and must be conducted in the same manner as a general meeting called by the Board.

Unless the Shareholders otherwise resolve by an ordinary resolution at the meeting called, the Company must reimburse the requisitioning Shareholders for the expenses reasonably incurred by them requisitioning, calling and holding the meeting.

The quorum for meetings of Shareholders is set forth in the Articles. A quorum for a meeting of Shareholders is two persons who are, or who represent by proxy, Shareholders who, in the aggregate, hold at least five per cent (5%) of the Company’s issued and outstanding common shares.

Procedures by which enquiries may be put to the Board

The BCBCA does not legislate procedures by which shareholder enquiries may be put to the board of a company and the Company’s constitutional documents do not mandate a specific process for enquiries to be put to the Board. However, Shareholders are kept informed of material information regarding the Company’s financial position and operations through annual public disclosure in accordance with applicable Canadian securities laws. Further, the Directors are obliged to place the annual financial statements of the Company and an Auditor’s report made on those financial statements before Shareholders at an Annual General Meeting and must send a copy of this information to Shareholders who request such information within six (6) months of the Annual General Meeting.

Should a Shareholder wish to communicate with the Board, they can contact the Company's Corporate Secretary at SouthGobi Resources Ltd., Suite 1100-355 Burrard Street, Vancouver, British Columbia, Canada V6C 2G8, Attention: Corporate Department, or by phone to 604-681-6799.

Procedures for putting forward proposals at Shareholders' Meetings

A qualified Shareholder (as herein defined) may put forward a written proposal setting out a matter that the qualified Shareholder wishes to have considered at the next Annual General Meeting. A qualified Shareholder is a Shareholder who is, and who has been for an uninterrupted period of at least two (2) years before the date of the signing of the proposal, a holder or beneficial owner of the Company's issued and outstanding common share(s) (subject to certain exceptions).

A valid proposal must be signed by the submitter and by qualified Shareholder(s) (each, a "Supporter") who, together with the submitter, is/are holders of common shares that, at the time of signing, in the aggregate constitute at least one per cent (1%) of the issued and outstanding common shares. A declaration signed by the submitter and each Supporter, must accompany the proposal, providing details as to contact and shareholdings of the submitter or the Supporter, as the case may be.

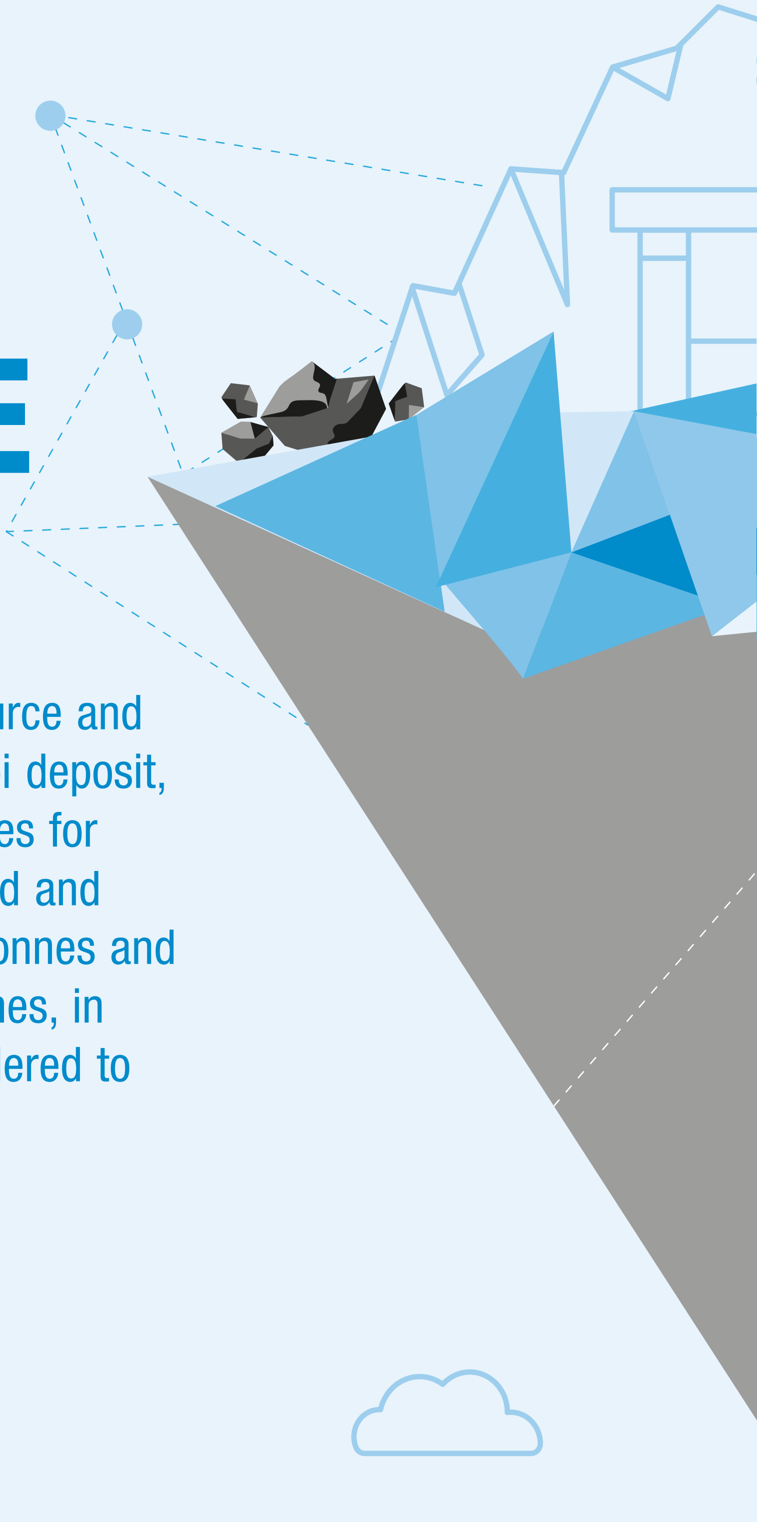
Each of the proposal and the declarations must be received at the registered office of the Company at least three (3) months before the anniversary of the previous year's annual general meeting and the Company must then (subject to certain statutory exceptions) send the text of the proposal to all holders of the Company's issued and outstanding common shares. The Company must allow a submitter to present the proposal at the Annual General Meeting in relation to which the proposal was made.

Constitutional documents

There were no changes in the constitutional documents of the Company during the Financial Year. The Articles are available on the respective websites of the Company and the Hong Kong Stock Exchange.

LARGE RESOURCE BASE

Following the updated mineral resource and reserve estimate for the Ovoot Tolgoi deposit, the Company's coal surface resources for the operating mine include measured and indicated resources of 194 million tonnes and inferred resources of 32 million tonnes, in which 114 million tonnes are considered to be proven and probable reserves.




BUCYRUS

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

Forward-looking statements

Except for statements of fact relating to SouthGobi Resources Ltd. and its subsidiaries, collectively "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", "could", "should", "seek", "likely", "estimate" 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 times 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 statements include, but are not limited to, statements regarding:

- the Company continuing as a going concern and its ability to realize its assets and discharge its liabilities in the normal course of operations as they become due; adjustments to the amounts and classifications of assets and liabilities in the Company's consolidated financial statements and the impact thereof;
- the Company's expectations of sufficient liquidity and capital resources to meets its ongoing obligations and future contractual commitments, including the Company's ability to settle the trade payables, to secure additional funding and to meet its obligations under each of the China Investment Corporation ("CIC") convertible debenture (the "CIC Convertible Debenture"), the Turquoise Hill Resources Ltd. ("Turquoise Hill") shareholder loan (the "TRQ Loan"), the short-term bridge loan and the bank loan, as the same become due;
- the Company's anticipated financing needs, development plans and future production levels;
- the ability of the Company to satisfy the Tax Penalty (as defined under the heading "REGULATORY ISSUES AND CONTINGENCIES – Governmental and Regulatory Investigations" in this Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"));
- the ability of the Company to meet the repayment terms as per the settlement agreement with Magnai Trade LLC ("MTLLC");
- the outcome of arbitration proceedings involving the Company and First Concept Logistics Limited ("First Concept") with respect to a coal supply agreement and payments thereunder;
- the results and impact of the Ontario class action (as described under the heading "REGULATORY ISSUES AND CONTINGENCIES – Class Action Lawsuit" in this MD&A);
- the estimates and assumptions included in the Company's impairment analysis and the possible impact of changes thereof;
- the Company's plans to file a technical report for the updated resource and reserve estimates and proposed mine plan described herein for the Ovoot Tolgoi Mine and the timing thereof;
- the possible impacts of changes in mine life, useful life or depreciation rates on depreciation expenses;
- the potential effects of a difference between future cash flows and profits from estimates;
- the ability to enhance the product value by conducting coal processing and coal washing;
- the expected impacts of the remaining administrative restrictions on certain of the Company's Mongolian assets and the anticipated impact on the Company's activities;
- the completion of the balance of the remaining title transfer registration for the residential units and parking spaces in Ulaanbaatar, Mongolia, the plan to commence the sales of such units, and receipt of the remaining cash portion of the associated settlement;

Forward-looking statements continued

- the agreement with Ejin Jinda and payments thereunder;
- the capacity and future toll rate of the paved highway;
- the potential effect of the list of licenses published by the Government of Mongolia covering areas in which exploration and mining are purportedly prohibited on certain of the Company's mining licenses;
- the Company's anticipated business activities, planned expenditures and corporate strategies;
- the Company's intention to develop markets for its semi-soft coking coal brands and to pursue long-term supply offtake agreements with end users in the People's Republic of China ("China");
- the future coal market conditions in China and the related impact on the Company's margins and liquidity;
- the costs relating to anticipated capital expenditures and the 2017 exploration program;
- the business outlook, including the outlook for the remainder of 2017 and beyond;
- the Company's objectives for 2017 and beyond;
- the plans for the progress of mining license application processes;
- the anticipated stock market conditions, the future prices of the Company's common shares (the "Common Shares") and ownership thereof;
- the possible impact of changes to the inputs to the valuation model used to value the embedded derivatives in the CIC Convertible Debenture;
- the impact of amendments to, or the application of, the laws of Mongolia, China and other countries in which the Company carries on business;
- the evaluation, and potential pursuit of, business opportunities other than coal mining, coal trading and real estate in Mongolia, including but not limited to power generation and contract mining;
- the impact of the Company's activities on the environment and actions taken for the purpose of mitigation of potential environmental impacts and planned focus on health, safety and environmental performance;
- the future mining operations at the Soumber Deposit (as defined under the heading "PROPERTIES – Development Projects and Exploration Program – Soumber Deposit" in this MD&A) being allowed to share the existing infrastructure with the Ovoot Tolgoi Mine;
- greenfield development options with the Soumber Deposit and Zag Suuj Deposit (as defined under the heading "PROPERTIES – Development Projects and Exploration Program" in this MD&A); and
- other statements that are not historical facts.

This list is not exhaustive of the factors that may affect any of the Company's forward-looking statements. 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 the forward-looking statements.

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

Table of Contents

Introduction

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") of SouthGobi Resources Ltd. (which, together with its subsidiaries, is collectively referred to as the "Company") should be read in conjunction with the consolidated financial statements of the Company and the notes thereto for the year ended December 31, 2016. The Company's consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

The consolidated financial statements are presented in the U.S. Dollar, which is the functional currency of SouthGobi Resources Ltd. and its controlled subsidiaries. The functional currency of RDCC LLC, the joint venture in respect of the paved highway and in which the Company has an indirect 40% interest, is the Mongolian Tugrik ("MNT"). The functional currency of the two 100% owned Chinese subsidiaries, Inner Mongolia SouthGobi Energy Limited, which was incorporated in June 2016, and SouthGobi Trading (Beijing) Co., Ltd., which was incorporated in May 2015, are the Renminbi. All figures in this MD&A are presented in U.S. Dollars unless otherwise stated.

Introduction continued

Disclosure of a scientific or technical nature in this MD&A in respect of the Company's material mineral projects was prepared by or under the supervision of the Qualified Persons (as that term is defined in National Instrument 43 – 101 of the Canadian Securities Administrators ("NI 43-101")) listed below.

Scientific and technical disclosure in respect of Ovoot Tolgoi Deposit has been reviewed and approved by Mr. Vincent Li and Dr. Weiliang Wang, directors of Dragon Mining Consulting Limited ("DMCL"). Specifically, Mr. Li and Dr. Wang were responsible for the fields of expertise described below in respect of the Ovoot Tolgoi Deposit. Other disclosures of a scientific or technical nature in this MD&A in respect of the Ovoot Tolgoi Mine were prepared by employees of the Company and reviewed by Mr. Li. Each of Mr. Li and Dr. Wang is a "qualified person" as that term is defined under NI 43-101. A technical report supporting the updated resources and reserves in respect of the Ovoot Tolgoi Deposit disclosed in this MD&A is being prepared and is expected to be filed on SEDAR within 45 days of the filing of this MD&A.

Disclosure of a scientific or technical nature relating to the Soumber Deposit is derived from a technical report on the Soumber Deposit dated March 25, 2013, prepared by RungePincockMinarco (known as Minarco-MineConsult as of the date of such report) (the "Soumber Technical Report") and scientific and technical disclosure relating to the Zag Suuj Deposit is derived from a technical report on the Zag Suuj Deposit dated March 25, 2013, prepared by RungePincockMinarco (known as Minarco-MineConsult as of the date of such report) (the "Zag Suuj Technical Report"). Copies of the Soumber Technical Report and the Zag Suuj Technical Report are available on SEDAR at www.sedar.com.

Property	Qualified Persons	Field of Expertise	Relationship to Company
Ovoot Tolgoi	Dr. Weiliang Wang	Resources	Independent Consultant
Ovoot Tolgoi	Vincent Li	Reserves	Independent Consultant
Soumber	Merryl Peterson	Resources	Independent Consultant
Zag Suuj	Merryl Peterson	Resources	Independent Consultant

1. Overview

The Company is an integrated coal mining, development and exploration company with 403 employees as at December 31, 2016. The Company'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 a 100% interest in the Ovoot Tolgoi open pit coal mine (the "Ovoot Tolgoi Mine") and the following significant development projects, the Soumber Deposit and the Zag Suuj 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, strategically located approximately 40km from the Shivee Khuren-Ceke crossing at the Mongolia-China border ("Shivee Khuren Border Crossing"), is the Company's flagship asset. The Company commenced mining at the Ovoot Tolgoi Mine in 2008. The Company sells a portion of its coal at the mine-gate to Chinese customers, while the remaining coal inventory is transported to China and sold via our Chinese subsidiaries at the stockyards in Ceke (Ceke, on the Chinese side of the Shivee Khuren Border Crossing, is a major Chinese coal distribution terminal with rail connections to key coal markets in China) or the designated location in China as requested by the customers.

Saleable products from the Ovoot Tolgoi Mine primarily include the SouthGobi standard ("Standard") and SouthGobi premium ("Premium") semi-soft coking coal products. Some higher-ash product is sold as a thermal coal product as and when the market allows.

1. Overview continued

Significant Events and Highlights

The Company's significant events and highlights for the year ended December 31, 2016 and the subsequent period to March 31, 2017 are as follows:

- ***Operating Results*** – Although coal prices generally improved in China during 2016, the impact of negotiating coal sales agreements during lower coal price periods and the depreciation of the Renminbi against the USD negatively impacted the overall coal prices achieved by the Company. The Company sold 1.08 million tonnes of coal during the fourth quarter of 2016 compared to 0.21 million tonnes in the fourth quarter of 2015. The production for the fourth quarter of 2016 was 1.21 million tonnes, compared to 0.62 million tonnes for the fourth quarter of 2015. The Company maintained a strong safety record and completed the fourth quarter of 2016 without any lost time injury.

- ***Financial Results*** – The Company recorded an $11.4 million loss from operations during the fourth quarter of 2016 as compared to a $105.1 million loss from operations in the fourth quarter of 2015. Revenue was $19.0 million in the fourth quarter of 2016 compared to $2.9 million in the fourth quarter of 2015. The operations during the fourth quarter of 2016 improved over the comparative 2015 quarter given the improved market conditions in China and the $92.7 million of impairment charges that were recorded in the fourth quarter of 2015 to reduce the carrying value of various items of property, plant and equipment to their recoverable amounts.

- ***Expanded Resources and Declared Reserves*** – As a result of work performed by DMCL, the Company increased its estimate of total resources at the Ovoot Tolgoi Deposit from those described in the technical report the Company filed in respect of the Ovoot Tolgoi Deposit in May 2016 (the "2016 Technical Report") and has declared reserves for the Ovoot Tolgoi Deposit. For more information on the resource and reserve estimates for the Ovoot Tolgoi Deposit, see the section 5 entitled Properties below.

- ***Settlement of Trade Receivable*** – During the year ended December 31, 2016, the Company entered into a settlement agreement with one of its major customers (the "Customer") pursuant to which 200 residential units and 40 parking spaces (collectively, the "240 Units") located in Ulaanbaatar, Mongolia, are to be transferred to the Company as partial consideration for settling an outstanding trade receivables in the amount of $12.0 million, with the balance of the receivable, totalling $7.5 million, payable in cash by the Customer to the Company by March 31, 2017 (subsequently extended to May 10, 2017). As the title transfers on the agreement could not be completed prior to December 31, 2016, the transaction cannot be completed and recorded in the Company's accounts until such titles are properly registered in the Company's name. The settlement agreement includes an option for the Company to return any unsold units back to the Customer, until September 30, 2017, at the same price per unit for immediate payment of the balance in cash. As of the date hereof, the title transfer registration in Mongolia has been completed for a material portion of the 240 Units, but additional time will be required to finalize the administrative process for the registration of the remaining portion of the 240 Units due to the number of units involved, the Company has been working closely with the government authority to facilitate the process. The Company anticipates that the title registration process will be completed and the sales of the 240 Units will commence during the second quarter of 2017. To March 31, 2017, the Company has collected $3.5 million from the Customer to settle the outstanding trade receivables and on March 27, 2017 entered into a deferral agreement to extend the payment due date on the remaining uncollected balance to May 10, 2017.

1. Overview continued

Significant Events and Highlights continued

- ***Short-term Bridge Loan*** – In October 2015, the Company entered into a short term bridge loan facility with an Asian based private equity fund for maximum proceeds of $10.0 million. The Company has repaid the first tranche of the short-term bridge loan of $5.0 million (inclusive of interest) up to August 11, 2016. During June and July 2016, the Company drew the second tranche of $5.0 million. $1.5 million has been matured in March 2017 and $3.5 million will mature in April 2017. In December 2016, $1.5 million was repaid for the short-term bridge loan and a further $1.8 million and $1.6 million was subsequently repaid in January 2017 and March 2017, respectively.

- ***Shareholder Loan*** – On May 16, 2016, Turquoise Hill signed a deferral letter agreement with the Company (the "May 2016 Deferral Letter Agreement"), in which Turquoise Hill agreed to a limited deferral of repayment of all remaining amounts and obligations owing under the TRQ Loan. The Company has agreed to repay $0.15 million per month from May 2016 to April 2017; and $0.2 million per month from May 2017 to December 2017, at which time all remaining obligations will become due. Interest shall continue to accrue on all outstanding obligations at the 12-month US dollar LIBOR rate. To date, the Company has made all payments due under the May 2016 Deferral Letter Agreement.

- ***CIC Convertible Debenture –*** On December 29, 2016, the Company executed the December 2016 Deferral Agreement ("December 2016 Deferral Agreement") with CIC for a revised repayment schedule on the $20.7 million of cash interest and associated costs originally due on December 19, 2016 ("December 2016 Deferral Amounts"). The key repayment terms of the December 2016 Deferral Agreement are: (i) the Company is required to repay $6.8 million of the cash interest and associated deferral fee costs in five monthly amounts during the period from December 2016 to April 2017; and (ii) the Company is required to repay $14.3 million of cash interest and associated costs on May 19, 2017. Although the Company has been in discussions with CIC for a further deferral, there can be no assurance that a favorable outcome can be reached. At any time before the December 2016 Deferral Amounts are fully repaid, the Company is required to consult with and obtain written consent from CIC prior to effecting a replacement or termination of either or both of its Chief Executive Officer and its Chief Financial Officer; otherwise this will constitute an event of default under the CIC Convertible Debenture, but CIC shall not withhold its consent if the board of directors proposes to replace either or both such officers with nominees selected by the Board, provided that the directors acted honestly and in good faith with a view to the best interests of the Company in the selection of the applicable replacements. To date, the Company has made all payments due under the December 2016 Deferral Agreement.

- ***Class Action Lawsuit*** – On May 24, 2016, the Ontario Superior Court of Justice (the "Ontario Court") granted the Company leave to appeal the decision made on November 5, 2015 (the "Corporation Appeal"), which granted the plaintiff permission to commence an action claiming damages under the Ontario Securities Act with respect to the Company's restatement of consolidated financial statements as previously disclosed in the Company's public filings. The plaintiff is also appealing the portion of the November 5, 2015 Ontario Court decision that dismissed the action against former officers and directors of the Company (the "Individual's Appeal").

  The Individuals' Appeal and the Corporation Appeal will now be verbally argued together. The appeals are scheduled to be heard by the Ontario Court of Appeal in June 2017. The Company disputes and is vigorously defending itself against the plaintiff's claims through independent Canadian litigation counsel retained by the Company and the other defendants for this purpose. Due to the inherent uncertainties of litigation, it is not possible to predict the final outcome of the appeals or determine the amount of potential losses, if any. However, the Company has judged a provision for this matter at December 31, 2016 is not required.

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

1. Overview continued

Significant Events and Highlights continued

- ***Tax Investigation Case in Mongolia*** – In May 2016, Resolution No.258 of the Government of Mongolia ("Resolution 258") was issued, which approved the Company's proposal to settle the Tax Penalty (as defined and described in section 7 entitled Regulatory Issues and Contingencies) by making a series of cash payments and by performing mining operation at the Tavan Tolgoi deposit in Southern Mongolia on behalf of Erdenes Tavan Tolgoi JSC ("Erdenes"), a company owned by the Government of Mongolia. During 2016, the Company made cash payments of $2.4 million as a partial settlement of the Tax Penalty.

  In compliance with the Resolution 258, in November 2016, the Company entered into an agreement with Erdenes under which the Company agreed to perform certain mining operations equivalent to MNT 20.3 billion (approximately $8.1 million) in the West Tsankhi section of the Tavan Tolgoi deposit during the period November 2016 to February 2017. As at December 31, 2016, the Company had performed mining operations consisting of drilling and blasting of rock mass, stripping and loading topsoil, selective excavation and loading coal, and creating overburden stockpiles at the Tavan Tolgoi deposit equivalent to MNT5.2 billion (approximately $2.1 million).

  As at December 31, 2016, the provision for the Tax Verdict (as defined in "Governmental and Regulator Investigations of Section 7 below) was reduced to $9.3 million.

  As of the date hereof the Company has completed the mining operations at the Tavan Tolgoi deposit equivalent to MNT20.3 billion (approximately $8.1 million) as set out in the agreement with Erdenes. The Company is required to make further cash payments of $3.0 million in 2017 to complete repayment of the balance of the penalty owing.

- ***Notice of Arbitration*** – The Company is subject to arbitration proceedings with First Concept with respect to a dispute with respect to the supply of coal under a coal sale agreement. The arbitration hearing with First Concept was held in the fourth quarter of 2016. The arbitration decision is expected to be released in the second quarter of 2017.

- ***Settlement of Claim by Former Chief Executive Officer*** – The claim by Mr. Alex Molyneux ("Mr. Molyneux"), the Company's former President and Chief Executive Officer, and the counterclaim by the Company, has been settled by a payment by the Company to Mr. Molyneux of the sum of $0.29 million, without admission of liability by either party. As a term of the settlement, the Company and Mr. Molyneux executed mutual general releases, and the action and counterclaim were dismissed as against all parties by consent without court costs payable to any party, effective on November 25, 2016.

- ***Settlement of Lawsuit Notice from a Former Fuel Supplier*** – On January 20, 2017, the Company announced that SouthGobi Sands LLC ("SGS"), a subsidiary of the Company, had received a lawsuit notice from the Khan-Uul District Civil Court of First Instance in Mongolia (the "DC Court") in relation to a claim from Magnai Trade LLC ("MTLLC"), a former fuel supplier of SGS, for MNT22.2 billion (approximately $8.9 million) consisting of MNT14.6 billion (approximately $5.8 million) of outstanding fuel supply payments and MNT7.6 billion (approximately $3.1 million) of late payment penalties and associated interest costs.

  Following SGS' successful challenge to the authority of the DC Court to hear the matter, the Company signed a settlement agreement with MTLLC on February 10, 2017, pursuant to which the outstanding amount of $7.9 million is required to be settled in equal monthly installments of $2.0 million from March 2017 to June 2017.

- ***Novel Sunrise Investments Limited ("Novel Sunrise") Sold 25.8 million Shares to a Company Owned by Members of Management*** – On January 11, 2017, Novel Sunrise, the Company's largest shareholder at the time, reported that it had sold 25.8 million common shares of the Company effective December 31, 2016 to Voyage Wisdom Limited ("Voyage Wisdom"), a company owned by three members of the Company's management team, for consideration of $24 million.

1. Overview continued

Significant Events and Highlights continued

- ***Changes in Directors***

  Mr. Huiyi Wang: Mr. Wang was appointed as a Non-Executive Director on February 18, 2016.

  Mr. Pierre Lebel: Mr. Lebel retired as Lead Director and an Independent Non-Executive Director on June 30, 2016.

  Mr. Joseph Belan: Mr. Belan was appointed as Independent Non-Executive Director of the Company on August 16, 2016.

- ***Strategic Advisor*** – On September 16, 2016, the Company established a Strategic Advisory Board and appointed Mr. Abraham (Braam) Jonker as its initial member. The purpose of the Strategic Advisory Board is to provide non-binding strategic guidance and advice to the Board of Directors of the Company in connection with the Company's ongoing business activities and initiatives.

- ***Going Concern*** – As at the date hereof, the Company has initiated a plan to change the existing product mix to higher value and higher margin outputs by washing certain grades of coal commencing in 2017 in order to produce more premium semi-soft coking coal and to initiate more processing of the lower grades of coal in order to reduce the ash content and improve the selling price and margins on its thermal coal product. The Company has also completed a new mine plan, which incorporates the coal washing and processing systems and contemplates significantly higher volumes of production in order to complement the Company's new product mix and sales volume targets. Such plans will involve the need for a significant level of stripping activities over the next two years and require certain capital expenditures to achieve the designed production outputs. Such expenditures will require the Company to seek additional financing in the form of finance leases, debt or equity. The Company has entered into an agreement for a finance lease on the new wash plant facility but will need financing to complete the thermal coal processing facilities.

  There is no guarantee that the Company will be able to successfully secure additional sources of financing. This could result in adjustments to the amounts and classifications of assets and liabilities in the Company's consolidated financial statements and such adjustments could be material. Unless the Company acquires additional sources of financing and/or funding in the short term, the ability of the Company to continue as a going concern is threatened. If the Company is unable to continue as a going concern, it may be forced to seek relief under applicable bankruptcy and insolvency legislation. See section 6 "Liquidity and Capital Resources" and section 14 "Risk Factors" for details. As at March 31, 2017, the Company had $5.3 million of cash.

2. Selected Annual Information

		Year ended December 31,				
$ in thousands, except per share and per tonne information		**2016**		2015		2014
Revenue [(i)]	**$**	**58,450**	$	16,030	$	24,494
Loss from operations		**(38,107)**		(166,917)		(82,734)
Net loss		**(60,846)**		(186,765)		(103,683)
Basic and diluted loss per share	**$**	**(0.24)**	$	(0.79)	$	(0.55)
Cash from/(used in) operating activities		**2,761**		(10,014)		(29,673)
Cash used in investing activities		**(1,530)**		(8,572)		(625)
Cash from/(used in) financing activities		**(579)**		15,202		12,378
Coal sales volumes *(millions of tonnes)* [(ii)]		**3.91**		1.07		2.04
Average realized selling price *(per tonne)* [(iii)]	**$**	**16.44**	$	17.66	$	14.76

		As at December 31,				
$ in thousands		**2016**		2015		2014
Cash and cash equivalents	**$**	**966**	$	377	$	3,789
Total working capital/(deficiency)		**(59,425)**		(42,322)		3,430
Total assets		**259,321**		290,474		416,139
Total non-current liabilities		**96,706**		95,137		95,590

(i) Revenue is presented after deduction of royalties and selling fees.

(ii) Coal sales volumes are from the Ovoot Tolgoi Mine.

(iii) Average realized selling price is presented before deduction of royalties and selling fees.

The coal market in China has remained challenging in 2014 and 2015 with certain coal price indices in China reached the lowest level in recent years. In 2014, the Company generated revenue of $24.5 million from mining activities at the Ovoot Tolgoi Mine.

In 2015, the Company continued to operate in a difficult market environment. Sales volume dropped to 1.07 million tonnes as compared to 2.04 million tonnes in 2014. The Company recorded $92.7 million of impairment charges to reduce various items of property, plant and equipment to their recoverable amounts in 2015.

Market conditions and prices for coal remained weak in China during the first half of 2016 despite a modest recovery of the general coal market in China in the second half. The improvement followed the implementation of China's national policy to reduce its coal production in order to accelerate supply-side reform and thereby seek to resolve the overcapacity issue in the medium term. The Company managed to increase in coal sales volume from 1.07 million tonnes in 2015 to 3.91 million tonnes in 2016. Although the average selling price remained challenged throughout 2016, the Company managed to expand its sales network and increase the number of customers from five in 2015 to 19 in 2016.

3. Overview of Operational Data and Financial Results

Summary of Annual Operational Data

	Year ended December 31, 2016	2015
Sales Volumes, Prices and Costs		
Premium semi-soft coking coal		
Coal sales *(millions of tonnes)*	**0.28**	0.22
Average realized selling price *(per tonne)* (i)	**$ 31.14**	$ 22.33
Standard semi-soft coking coal		
Coal sales *(millions of tonnes)*	**2.52**	0.59
Average realized selling price *(per tonne)* (i)	**$ 16.71**	$ 19.12
Thermal coal		
Coal sales *(millions of tonnes)*	**1.11**	0.26
Average realized selling price *(per tonne)* (i)	**$ 12.16**	$ 10.24
Total		
Coal sales *(millions of tonnes)*	**3.91**	1.07
Average realized selling price *(per tonne)* (i)	**$ 16.44**	$ 17.66
Raw coal production *(millions of tonnes)*	**3.38**	1.95
Cost of sales of product sold *(per tonne)*	**$ 22.26**	$ 59.52
Direct cash costs of product sold *(per tonne)* (ii)	**$ 8.66**	$ 13.63
Mine administration cash costs of product sold *(per tonne)* (ii)	**$ 2.32**	$ 3.44
Total cash costs of product sold *(per tonne)* (ii)	**$ 10.98**	$ 17.07
Other Operational Data		
Production waste material moved *(millions of bank cubic meters)*	**7.38**	7.02
Strip ratio *(bank cubic meters of waste material per tonne of coal produced)*	**2.18**	3.60
Lost time injury frequency rate (iii)	**0.00**	0.00

(i) Average realized selling price is presented before deduction of royalties and selling fees.

(ii) A non-IFRS financial measure, see section 4. Cash costs of product sold exclude idled mine asset cash costs.

(iii) Per 200,000 man hours and calculated based on a rolling 12 month average.

3. Overview of Operational Data and Financial Results continued

Overview of Annual Operational Data

The Company ended 2016 without any lost time injury. As at December 31, 2016, the Company had a lost time injury frequency rate of nil per 200,000 man hours based on a rolling 12 month average.

The market conditions remained difficult in the first half of 2016 despite a modest recovery in the second half of 2016 following the implementation of China's national policy of restricting coal production described above. The overall price for coal improved in China in 2016, but these improvements were negatively impacted by certain coal sale contracts negotiated at a time of lower coal prices. In addition, the depreciation of the Renminbi against the USD hindered the positive impact of increased coal prices.

The Company managed to increase its sales volume from 1.07 million tonnes in 2015 to 3.91 million tonnes in 2016; however, the average realized selling price decreased from $17.66 per tonne in 2015 compared to $16.44 per tonne in 2016 which was mainly a result of the product mix as well as the depreciation of the Renminbi against the USD. The product mix for 2016 consisted of approximately 7% of Premium semi-soft coking coal, 64% of Standard semi-soft coking coal and 29% of thermal coal compared to approximately 21% of Premium semi-soft coking coal, 55% of Standard semi-soft coking coal and 24% of thermal coal in 2015.

The Company's production in 2016 was higher than 2015 as a result of ramping up production to meet the expected increase in sales, yielding 3.38 million tonnes for 2016 as compared to 1.95 million tonnes for 2015.

The Company's unit cost of sales of product sold decreased to $22.26 per tonne for the year ended December 31, 2016 from $59.52 per tonne in the year ended December 31, 2015. The decrease was mainly driven by the increased sales and the related economies of scale while less coal stockpile inventory impairments was recorded for the year 2016.

Summary of Annual Financial Results

$ in thousands, except per share information	Year ended December 31, 2016	2015
Revenue (i),(ii)	**$ 58,450**	$ 16,030
Cost of sales (ii)	**(87,045)**	(63,691)
Gross loss excluding idled mine asset costs	**(16,490)**	(22,226)
Gross loss including idled mine asset costs	**(28,595)**	(47,661)
Other operating expenses	**(50)**	(18,951)
Administration expenses	**(7,888)**	(7,509)
Evaluation and exploration expenses	**(422)**	(145)
Impairment of property, plant and equipment	**(1,152)**	(92,651)
Loss from operations	**(38,107)**	(166,917)
Finance costs	**(22,314)**	(21,371)
Finance income	**239**	1,302
Share of earnings of a joint venture	**806**	225
Income tax expense	**(1,470)**	(4)
Net loss	**(60,846)**	(186,765)
Basic and diluted loss per share	**$ (0.24)**	$ (0.79)

(i) Revenue is presented after deduction of royalties and selling fees.

(ii) Revenue and cost of sales relate to the Company's Ovoot Tolgoi Mine within the Mongolian Coal Division operating segment. Refer to note 4 of the consolidated financial statements for further analysis regarding the Company's reportable operating segments.

3. Overview of Operational Data and Financial Results continued

Overview of Annual Financial Results

The Company recorded a $38.1 million loss from operations in 2016 compared to a $166.9 million loss from operations in 2015. Although the general coal market remained difficult in 2016, the 2016 results were an improvement when compared to 2015 and were principally attributable to increased coal sales as well as decrease of impairment of property, plant and equipment from $92.7 million in 2015 to $1.2 million in 2016.

Revenue was $58.5 million in 2016 compared to $16.0 million in 2015. The Company sold 3.91 million tonnes of coal in 2016 as compared to 1.07 million tonnes in 2015.

The Company's revenue is presented after deduction of royalties and selling fees. The Company's effective royalty rate for 2016, based on the Company's average realized selling price of $16.44 per tonne, was 7.0% or $1.14 per tonne compared to 12.7% or $2.25 per tonne based on the average realized selling price of $17.66 per tonne in 2015.

Royalty regime in Mongolia

The royalty regime in Mongolia is evolving and has been subject to change since 2012.

On January 1 2015, the "flexible tariff" royalty regime ended and royalty payments reverted to the previous regime which is based on a set reference price per tonne published monthly by the Government of Mongolia. The Company and other Mongolian coal producers are actively engaging the Mongolian authorities to seek the continuation of the "flexible tariff" regime.

On February 1, 2016, the Government of Mongolia issued a resolution in connection with the royalty regime. From February 1, 2016 onwards, royalties are to be calculated based on the actual contract price in which transportation cost to the Mongolia border should have been included. If such transportation cost was not included in the contract, the relevant transportation costs, custom documentation fees, insurance and loading cost should be estimated for the calculation of royalties. In the event that the calculated sales price as described above differs from the contract sales price of other entities in Mongolia (same quality of coal and same border crossing) by more than 10%, the calculated sales price will be deemed to be "non-market" under Mongolian tax law and the royalty will then be calculated based on a reference price as determined by the Government of Mongolia. No contracts of the Company were deemed as "non-market" during 2016. See "Risk Factors – Company's Projects in Mongolia".

Cost of sales was $87.0 million in 2016 compared to $63.7 million in 2015. Cost of sales comprises operating expenses, share-based compensation expense, equipment depreciation, depletion of mineral properties, coal stockpile inventory impairments and idled mine asset costs. Operating expenses in cost of sales reflect the total cash costs of product sold (a Non-IFRS financial measure; see section 4 for further analysis) during the year.

$ in thousands	Year ended December 31, 2016	2015
Operating expenses	**$ 41,452**	$ 18,266
Share-based compensation expense/(recovery)	**(8)**	42
Depreciation and depletion	**26,142**	5,361
Impairment of coal stockpile inventories	**7,354**	14,588
Cost of sales from mine operations	**74,940**	38,257
Cost of sales related to idled mine assets	**12,105**	25,434
Cost of sales	**$ 87,045**	$ 63,691

3. Overview of Operational Data and Financial Results continued

Overview of Annual Financial Results continued

Operating expenses in cost of sales were $41.5 million in 2016 compared to $18.3 million in 2015. The overall increase in operating expenses was primarily the result of the net effect of (i) increased sales volume from 1.07 million tonnes in 2015 to 3.91 million tonnes in 2016; (ii) reduced impairment of coal stockpile inventories and (iii) continued focus on cost saving initiatives.

Cost of sales in 2016 and 2015 included coal stockpile impairments of $7.4 million and $14.6 million, respectively, to reduce the carrying value of the Company's coal stockpiles to their net realizable value. The coal stockpile impairments recorded in both years reflected the challenging coal market conditions and primarily related to the Company's higher-ash content products.

Cost of sales related to idled mine asset costs primarily consisted of periodic costs, which were expensed as incurred and included mainly depreciation expense. Cost of sales related to idled mine assets in 2016 included $12.1 million related to depreciation expenses for idled equipment (2015: $22.5 million). The drop of cost of sales related to idled mine assets was mainly due to the increase in production during 2016 which results a higher utilization rate for the machinery and related assets.

Other operating expenses were negligible in 2016 compared to $19.0 million in 2015.

$ in thousands	Year ended December 31, 2016		2015
Foreign exchange gain	$	**(5,423)**	$ (896)
Discount on settlement of trade payables		**(1,009)**	–
Mining services, net		**1,006**	–
Settlement of civil claims		**2,652**	–
Provision for doubtful trade and other receivable		**2,641**	161
Loss on settlement of prepayments		**–**	712
Impairment of materials and supplies inventories		**–**	675
Provision for court case penalty		**–**	18,049
Other		**183**	250
Other operating expenses	$	**50**	$ 18,951

A foreign exchange gain of $5.4 million (2015: $0.9 million) was recorded as a result of the significant depreciation of MNT against USD during the fourth quarter of 2016. The key underlying drivers of the forex gain are that most trade and other payables and the Tax Penalty are denominated in MNT.

The Company made a provision for doubtful trade and other receivables of $2.6 million (2015: $0.2 million) for the long aged receivables. As at December 31, 2016, the Company had gross receivables of $19.2 million due from the Customer. Of this amount approximately $12.0 million is expected to be settled in due course in exchange for the 240 Units in Mongolia. See section 1 "Overview" for details. The 240 Units are located in Ulaanbaatar, Mongolia and were constructed in 2013. The total saleable area of the residential units is approximately 13,790 square meter. The size of each residential unit range from 42 square meter to 94 square meter. The balance outstanding from December 31, 2016, after deducting the $12.0 million, was to be paid by March 31, 2017 pursuant to the same agreement related to the residential real estate transaction. To March 31, 2017, the Company has collected $3.5 million from the Customer and on March 27, 2017 entered into a deferral agreement to extend the payment due date on the remaining uncollected balance to May 10, 2017.

In 2015, the Company recognized an expense for the provision of the Tax Penalty of $18.0 million.

Mining services at the Tavan Tolgoi deposit were provided in connection with settlement of the Tax Penalty at a net cost of $1.0 million in 2016 (Direct mining costs and depreciation totaling $3.1 million, net of service revenue of $2.1 million) (refer to "Governmental and Regulatory Investigations" of Section 7 for details), with no similar amount incurred in 2015.

3. Overview of Operational Data and Financial Results continued

Overview of Annual Financial Results continued

Refer to "Settlement of Lawsuit Notice from a Former Fuel Supplier" and "Settlement of Claim by Former Chief Executive Officer" of Section 7 for details of the settlement of civil claims with MTLLC of $2.4 million and with Mr. Molyneux of $0.29 million, respectively.

Administration expenses were $7.9 million in 2016 as compared to $7.5 million in 2015. The increase in corporate administration and salaries and benefits was mainly due to the operations of the new subsidiary in China, which was incorporated in June 2016 to expand the sales channels of coal in China.

	Year ended December 31,	
$ in thousands	**2016**	2015
Corporate administration	**$ 2,724**	$ 2,112
Legal and professional fees	**2,022**	2,921
Salaries and benefits	**2,820**	2,155
Share-based compensation expense	**58**	199
Depreciation	**264**	122
Administration expenses	**$ 7,888**	$ 7,509

Evaluation and exploration expenses were $0.4 million in 2016 as compared to $0.1 million in 2015. The Company continued to minimize evaluation and exploration expenditures in 2016 in order to preserve the Company's financial resources. Evaluation and exploration activities and expenditures in 2016 were limited to ensuring that the Company met the Mongolian Minerals Law requirements in respect of its mining and exploration licenses.

Given the difficult market conditions, the associated delays in projects and the commissioning of equipment, the Company recorded $92.7 million of impairment charges to reduce various items of property, plant and equipment to their recoverable amounts for the year ended December 31, 2015. In particular, after conducting an impairment test on the Ovoot Tolgoi Mine cash generating unit, the Company recorded a $76.7 million impairment charge in 2015 (refer to "Ovoot Tolgoi Mine Impairment Analysis" of Section 6 for details). After a further review of the dry coal handling facility ("DCHF") in the fourth quarter of 2015 related to the new mine plan, the Company concluded that there was no longer a plan to restart the DCHF project or to utilize the facility. As a result, the Company recorded an $8.5 million impairment charge in 2015 to reduce the carrying value of the DCHF to $nil as at December 31, 2015. For the year ended December 31, 2016, the Company again identified impairment indicators for the Ovoot Tolgoi Mine cash generating unit and conducted an impairment test. Following the slight market recovery in 2016 as well as the successful implementation of the Company's business plan, no general impairment charges and no impairment reversal was determined. A specific impairment charge of $1.2 million was made for the year ended December 31, 2016 on the deposits related to pending purchases of property, plant and equipment.

Finance costs were $22.3 million and $21.4 million in 2016 and 2015 respectively, which primarily consisted of interest expense on the $250.0 million CIC Convertible Debenture.

Finance income was $0.2 million in 2016 compared to $1.3 million in 2015, which primarily related to unrealized gains on the change in fair value of the embedded derivatives in the CIC Convertible Debenture ($0.2 million and $1.1 million for 2016 and 2015, respectively). The fair value of the embedded derivatives in the CIC Convertible Debenture is driven by many factors including: the Company's common share price, the USD and Canadian Dollar exchange rate and share price volatility.

3. Overview of Operational Data and Financial Results continued

Summary of Quarterly Operational Data

		2016				2015		
Quarter Ended		**31-Dec**	**30-Sep**	**30-Jun**	**31-Mar**	31-Dec	30-Sep	30-Jun	31-Mar
Sales Volumes, Prices and Costs									
Premium semi-soft coking coal									
Coal sales *(millions of tonnes)*		**0.15**	**0.07**	**–**	**0.06**	0.04	0.16	0.02	–
Average realized selling price *(per tonne)* (i)	$	**40.49**	$ **21.04**	$ **–**	$ **21.38**	$ 21.72	$ 22.32	$ 23.37	$ –
Standard semi-soft coking coal									
Coal sales *(millions of tonnes)*		**0.65**	**0.77**	**0.52**	**0.58**	0.12	0.31	0.11	0.05
Average realized selling price *(per tonne)* (i)	$	**16.79**	$ **15.66**	$ **16.27**	$ **18.42**	$ 18.91	$ 19.10	$ 19.97	$ 17.95
Thermal coal									
Coal sales *(millions of tonnes)*		**0.28**	**0.29**	**0.30**	**0.24**	0.05	0.02	0.06	0.13
Average realized selling price *(per tonne)* (i)	$	**15.26**	$ **14.79**	$ **9.17**	$ **9.19**	$ 9.26	$ 10.48	$ 10.47	$ 10.46
Total									
Coal sales *(millions of tonnes)*		**1.08**	**1.13**	**0.82**	**0.88**	0.21	0.49	0.19	0.18
Average realized selling price *(per tonne)* (i)	$	**19.55**	$ **15.79**	$ **13.65**	$ **16.11**	$ 17.19	$ 19.76	$ 17.42	$ 12.66
Raw coal production *(millions of tonnes)*		**1.21**	**1.13**	**0.67**	**0.37**	0.62	0.71	0.62	–
Cost of sales of product sold *(per tonne)*	$	**21.15**	$ **19.53**	$ **28.01**	$ **21.62**	$ 56.59	$ 44.86	$ 60.75	$ 98.95
Direct cash costs of product sold *(per tonne)* (ii)	$	**7.97**	$ **7.13**	$ **12.47**	$ **7.88**	$ 6.55	$ 17.46	$ 15.57	$ 8.68
Mine administration cash costs of product sold *(per tonne)* (ii)	$	**3.23**	$ **2.26**	$ **2.32**	$ **1.24**	$ 1.78	$ 2.81	$ 7.90	$ 2.11
Total cash costs of product sold *(per tonne)* (ii)	$	**11.20**	$ **9.39**	$ **14.79**	$ **9.12**	$ 8.33	$ 20.27	$ 23.47	$ 10.79
Other Operational Data									
Production waste material moved *(millions of bank cubic meters)*		**2.62**	**2.22**	**1.82**	**0.72**	1.08	2.33	3.62	–
Strip ratio *(bank cubic meters of waste material per tonne of coal produced)*		**2.16**	**1.96**	**2.71**	**1.94**	1.75	3.25	5.87	–
Lost time injury frequency rate (iii)		**0.00**	**0.00**	**0.00**	**0.00**	0.00	0.00	0.00	0.25

(i) Average realized selling price is presented before deduction of royalties and selling fees.

(ii) A non-IFRS financial measure, see section 4. Cash costs of product sold exclude idled mine asset cash costs.

(iii) Per 200,000 man hours and calculated based on a rolling 12 month average.

Overview of Quarterly Operational Data

The Company maintained a strong safety record and completed the fourth quarter of 2016 without any lost time injury.

Although market conditions and prices for coal improved in China in the fourth quarter of 2016, the impact of these conditions was partially offset by the Company being required to sell coal pursuant to the sales agreements which were negotiated at a time of lower coal prices, and the depreciation of the Renminbi against the USD. The Company sold 1.08 million tonnes of its coal products during the fourth quarter of 2016 compared to 0.21 million tonnes for the fourth quarter of 2015. The Company also improved the pacing of production to meet demand, such that production was 1.21 million tonnes for the fourth quarter of 2016 as compared to 0.62 million tonnes for the fourth quarter of 2015.

3. Overview of Operational Data and Financial Results continued

Summary of Quarterly Financial Results

The Company's consolidated financial statements are reported under IFRS issued by the IASB. The following table provides highlights from the Company's consolidated financial statements of quarterly results for the past eight quarters.

$ in thousands, except per share information	2016				2015			
Quarter Ended	**31-Dec**	**30-Sep**	**30-Jun**	**31-Mar**	31-Dec	30-Sep	30-Jun	31-Mar
Financial Results								
Revenue [(i), (ii)]	**$ 18,983**	**$ 16,379**	**$ 10,361**	**$ 12,727**	$ 2,873	$ 8,620	$ 2,949	$ 1,587
Cost of sales [(ii)]	**(22,842)**	**(22,018)**	**(23,105)**	**(19,080)**	(12,072)	(22,108)	(11,833)	(17,678)
Gross loss excluding idled mine asset costs	**(2,353)**	**(3,162)**	**(9,926)**	**(1,049)**	(5,338)	(10,642)	(5,017)	(1,230)
Gross loss including idled mine asset costs	**(3,859)**	**(5,639)**	**(12,744)**	**(6,353)**	(9,199)	(13,488)	(8,884)	(16,091)
Other operating income/(expenses)	**(3,782)**	**4,631**	**812**	**(1,711)**	(1,093)	621	(19,450)	971
Administration expenses	**(2,378)**	**(2,042)**	**(1,826)**	**(1,642)**	(2,154)	(1,967)	(1,963)	(1,425)
Evaluation and exploration expenses	**(222)**	**(101)**	**(52)**	**(47)**	(46)	(40)	22	(81)
Impairment of property, plant and equipment	**(1,152)**	**–**	**–**	**–**	(92,651)	–	–	–
Loss from operations	**(11,393)**	**(3,151)**	**(13,810)**	**(9,753)**	(105,143)	(14,873)	(30,275)	(16,626)
Finance costs	**(5,645)**	**(6,358)**	**(5,377)**	**(5,497)**	(5,694)	(5,351)	(5,222)	(6,648)
Finance income	**472**	**5**	**324**	**1**	580	1,984	274	8
Share of earnings/(losses) of a joint venture	**378**	**89**	**256**	**83**	(7)	99	151	(18)
Income tax credit/(expense)	**(1,294)**	**82**	**(23)**	**(235)**	(2)	(1)	(1)	–
Net loss	**(17,482)**	**(9,333)**	**(18,630)**	**(15,401)**	(110,266)	(18,142)	(35,073)	(23,284)
Basic and dilute loss per share	**$ (0.07)**	**$ (0.04)**	**$ (0.07)**	**$ (0.06)**	$ (0.44)	$ (0.07)	$ (0.15)	$ (0.11)

(i) Revenue is presented after deduction of royalties and selling fees.

(ii) Revenue and cost of sales relate to the Company's Ovoot Tolgoi Mine within the Mongolian Coal Division operating segment. Refer to note 4 of the consolidated financial statements for further analysis regarding the Company's reportable operating segments.

Overview of Quarterly Financial Results

The Company recorded an $11.4 million loss from operations in the fourth quarter of 2016 compared to a $105.1 million loss from operations in the fourth quarter of 2015. The operations for the three months ended December 31, 2016 improved given the improved market conditions in China.

Revenue was $19.0 million in the fourth quarter of 2016 compared to $2.9 million in the fourth quarter of 2015. The Company sold 1.08 million tonnes of coal at an average realized selling price of $19.55 per tonne in the fourth quarter of 2016 compared to sales of 0.21 million tonnes at an average realized selling price of $17.19 per tonne in the fourth quarter of 2015. Revenue increased in the fourth quarter of 2016 compared to the fourth quarter of 2015 as a combined result of the higher sales volumes as well as the improved average selling price.

The Company's revenue is presented after deduction of royalties and selling fees. The Company's effective royalty rate for the fourth quarter of 2016, based on the Company's average realized selling price of $19.55 per tonne, was 7.0% or $1.36 per tonne while the Company's effective royalty rate was 13.8% or $2.38 per tonne based on the average realized selling price of $17.19 per tonne in the fourth quarter of 2015. The difference in the effective royalty rate was mainly driven by the change in the royalty regime which has been based on the actual contract price since February 2016 (refer to "Royalty regime in Mongolia" in this MD&A for details).

3. Overview of Operational Data and Financial Results continued

Overview of Quarterly Financial Results continued

Cost of sales was $22.8 million in the fourth quarter of 2016 compared to $12.1 million in the fourth quarter of 2015. Cost of sales comprises operating expenses, share-based compensation expense, equipment depreciation, depletion of mineral properties, coal stockpile inventory impairments and idled mine asset costs. Operating expenses in cost of sales reflect the total cash costs of product sold (a Non-IFRS financial measure. See section 4 for further analysis) during the period.

$ in thousands	Three months ended December 31, 2016	2015
Operating expenses	**$ 12,095**	$ 1,780
Share-based compensation expense/(recovery)	**(2)**	8
Depreciation and depletion	**9,127**	946
Impairment of coal stockpile inventories	**116**	5,477
Cost of sales from mine operations	**21,336**	8,211
Cost of sales related to idled mine assets	**1,506**	3,861
Cost of sales	**$ 22,842**	$ 12,072

Operating expenses included in cost of sales were $12.1 million in the fourth quarter of 2016 as compared to $1.8 million in the fourth quarter of 2015. The overall increase in operating expenses was primarily the net effect of (i) the increase in sales volume from 0.21 million tonnes in the fourth quarter of 2015 to 1.08 million tonnes in the fourth quarter of 2016; (ii) reduced impairment of coal stockpile inventories and (iii) continued focus on cost saving initiatives.

The depreciation and depletion portion of cost of sales increased to $9.1 million in the fourth quarter of 2016 from $0.9 million in the fourth quarter of 2015. The increase was mainly due to the increase in sales volume.

Cost of sales in the fourth quarter of 2016 and the fourth quarter of 2015 included coal stockpile impairments of $0.1 million and $5.5 million, respectively, to reduce the carrying value of the Company's coal stockpiles to their net realizable value. The coal stockpile impairments recorded in both periods reflect the challenging coal market conditions and primarily related to the Company's higher-ash products. The lower balance for the fourth quarter of 2016 was mainly due to the recovery of coal market as evidenced by a higher selling price.

Idled mine asset costs in the fourth quarter of 2016 included depreciation expense for idled mine equipment of $1.5 million (2015: $3.9 million).

Other operating expenses were $3.8 million in the fourth quarter of 2016 (2015: $1.1 million).

$ in thousands	Three months ended December 31, 2016	2015
Foreign exchange gain	**$ (2,281)**	$ (355)
Mining services, net	**1,006**	–
Settlement of civil claims	**2,362**	–
Loss on settlement of prepayments	**–**	712
Impairment of materials and supplies inventories	**–**	675
Provision for doubtful trade and other receivables	**2,639**	4
Other	**56**	57
Other operating expenses	**$ 3,782**	$ 1,093

The foreign exchange gain of $2.3 million for the fourth quarter of 2016 (2015: $0.4 million) was recorded as a result of the significant depreciation of the MNT against the USD. The key underlying drivers of the foreign exchange gain are that most trade and other payables and the Tax Penalty are denominated in MNT.

3. Overview of Operational Data and Financial Results continued

Overview of Quarterly Financial Results continued

Mining services at the Tavan Tolgoi deposit were provided in connection with settlement of the Tax Penalty at a net cost of $1.0 million for the fourth quarter of 2016 (Direct mining costs and depreciation totaling $3.1 million, net of service revenue of $2.1 million) (refer to "Governmental and Regulatory Investigations" of Section 7 for details), with no similar amount incurred for the fourth quarter of 2015.

The Company made a provision for doubtful trade and other receivables of $2.6 million in the fourth quarter of 2016 (2015: negligible) for the long aged receivables.

Refer to "Settlement of Lawsuit Notice from a Former Fuel Supplier" of Section 7 for details of the settlement of civil claims with MTLLC of $2.4 million.

In the fourth quarter of 2015, the Company also recognized an impairment charge of $0.7 million in respect of obsolete materials and supplies inventories as the Company continued to operate below capacity in 2015 (2016: nil).

Administration expenses were $2.4 million in the fourth quarter of 2016 as compared to $2.2 million in the fourth quarter of 2015. The increase in corporate administration and salaries and benefit was mainly due to the operations of a new subsidiary in China which was incorporated in June 2016 to expand the sale channels of coal in China.

$ in thousands	Three months ended December 31, 2016	2015
Corporate administration	**$ 689**	$ 647
Legal and professional fees	**727**	786
Salaries and benefits	**787**	682
Share-based compensation expense	**26**	12
Depreciation	**149**	27
Administration expenses	**$ 2,378**	$ 2,154

Evaluation and exploration expenses were $0.2 million in the fourth quarter of 2016 as compared to $0.1 million in the fourth quarter of 2015. The Company continued to minimize evaluation and exploration expenditures in order to preserve the Company's financial resources. Evaluation and exploration activities and expenditures in the fourth quarter of 2016 were limited to ensuring that the Company met the Mongolian Minerals Law requirements in respect of its mining and exploration licenses.

Given the difficult market conditions and the associated delays in projects and the commissioning of equipment, the Company recorded $92.7 million of impairment charges to reduce various items of property, plant and equipment to their recoverable amounts in the fourth quarter of 2015. In particular, after conducting an impairment test on the Ovoot Tolgoi Mine cash generating unit, the Company recorded a $76.7 million impairment charge in 2015. A further review has been performed on DCHF in the fourth quarter of 2015 related to the new mine plan. The Company concluded that there is no longer a plan to restart the DCHF project or utilize the facility. As a result, the Company recorded an $8.5 million impairment charge in 2015 to reduce the carrying value of the DCHF to $nil as at December 31, 2015. For the year ended December 31, 2016, the Company again identified impairment indicators for the Ovoot Tolgoi Mine cash generating unit and conducted an impairment test. Following the slight market recovery in 2016 as well as the successful implementation of the Company's business plan, no general impairment charge and no impairment reversal was determined. A specific impairment charge of $1.2 million was made in the fourth quarter of 2016 on the deposits related to pending purchases of property, plant and equipment.

Finance costs were $5.6 million in the fourth quarter of 2016 compared to $5.7 million in the fourth quarter of 2015, which primarily consisted of interest expense on the CIC Convertible Debenture.

3. Overview of Operational Data and Financial Results continued

Overview of Quarterly Financial Results continued

Finance income was $0.5 million in the fourth quarter of 2016 compared to $0.6 million in the fourth quarter of 2015, which primarily consisted of unrealized gains on the fair value change of the embedded derivatives in the CIC Convertible Debenture. The fair value of the embedded derivatives in the CIC Convertible Debenture is driven by many factors including: the Company's common share price, U.S. Dollar and Canadian Dollar exchange rates and share price volatility.

4. Non-IFRS Financial Measures

The Company has included the non-IFRS financial measure "cash costs" in this MD&A to supplement its consolidated financial statements, which have been prepared in accordance with IFRS.

The Company believes that this measure, together with measures determined in accordance with IFRS, provides 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 non-IFRS financial measure 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, with the exception of idled mine asset costs and non-cash expenses which are excluded. Non-cash expenses include share-based compensation expense, impairments of coal stockpile inventories, depreciation and depletion of property, plant and equipment and 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.

The cash costs of product sold presented below may differ from cash costs of product produced depending on the timing of coal stockpile inventory turnover and impairments of coal stockpile inventories from prior periods.

$ in thousands, except per tonne information	Three months ended December 31, 2016	2015	Year ended December 31, 2016	2015
Cash costs				
Cost of sales determined in accordance with IFRS	**$ 22,842**	$ 12,072	**$ 87,045**	$ 63,691
Less non-cash expenses	**(9,241)**	(6,431)	**(32,014)**	(19,991)
Less non-cash idled mine asset costs	**(1,506)**	(3,861)	**(12,105)**	(22,463)
Total cash costs	**12,095**	1,780	**42,926**	21,237
Less idled mine asset cash costs	**–**	–	**–**	(2,972)
Total cash costs excluding idled mine asset cash costs	**12,095**	1,780	**42,926**	18,265
Coal sales *(millions of tonnes)*	**1.08**	0.21	**3.91**	1.07
Total cash costs of product sold *(per tonne)*	**$ 11.20**	$ 8.34	**$ 10.98**	$ 17.07

4. Non-IFRS Financial Measures continued

Cash Costs continued

$ in thousands, except per tonne information	Three months ended December 31, **2016**	2015	Year ended December 31, **2016**	2015
Cash costs				
Direct cash costs of product sold *(per tonne)*	**$ 7.97**	$ 6.56	**$ 8.66**	$ 13.63
Mine administration cash costs of product sold *(per tonne)*	**3.23**	1.78	**2.32**	3.44
Total cash costs of product sold *(per tonne)*	**$ 11.20**	$ 8.34	**$ 10.98**	$ 17.07

The cash cost of product sold per tonne was $10.98 for 2016, which was a significant decrease from the cash cost of $17.07 per tonne for 2015. The reason for the decrease is primarily related to the production costs being shared by a larger volume of coal sales. (3.91 million tonnes for 2016 as compared to (1.07 million tonnes for 2015).

5. Properties

The Company currently holds six mining licenses in Mongolia.

The mining licenses pertain to the Ovoot Tolgoi Mine (12726A), the Soumber Deposit (MV-016869, MV-025436 and MV-020451) and the Zag Suuj deposit (MV-020676 and MV-020675).

Two exploration licenses (9443X and 9449X) were converted to mining licenses (MV-025436 and MV-020451) by the Mineral Resources Authority of Mongolia ("MRAM") in January 2016 while the other two exploration licenses (13779X and 5267X) were converted to mining licenses (MV-020676 and MV-020675) by the MRAM in November 2016.

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, 320km southwest of the provincial capital of Dalanzadgad and 950km southwest of the nation's capital of Ulaanbaatar. 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.

Saleable products from the Ovoot Tolgoi Mine primarily include the Standard and Premium semi-soft coking coal products. The Company's raw semi-soft products together with raw higher-ash coals are suitable for washing and blending in order to be sold as a 1/3 coking coal in the Chinese market. Some higher-ash product is sold as a thermal coal product as and when the market allows. The Company intends to continue to develop markets for both its Premium and Standard semi-soft coking coal brands and to pursue long-term supply offtake with end users in China to complement its existing customer base and to gain best value for the Company's coal in the Chinese market. The Company is committed to further enhancing the quality of its coal products through wet washing and increasing its market penetration in China.

5. Properties continued

Operating Mines continued

Resources

The term "resource" is utilized to quantify coal contained in seams occurring within specified limits of thickness and depth from surface considered by the Qualified Person to have reasonable prospects for eventual economic extraction. For a complete description of a resource, refer to "mineral resource" under the heading "DEFINITIONS AND OTHER INFORMATION – Glossary of Geological and Mining Terms" in the Company's Annual Information Form dated March 31, 2017. The resource estimates presented are on an in-place basis, i.e., without adjustment for mining losses or coal recovery. Minimum seam thickness and maximum parting thickness are considered and coal intervals not meeting these criteria are not included in the reported resources.

In accordance with NI 43-101, DMCL has made reference to the GSC Paper 88-21 during the classification, estimation and reporting of coal resources for the Ovoot Tolgoi Deposit. The exercise of resource classification is initially made based on the Geology-Type of the coal deposits as defined in the GSC Paper 88-21. According to the level of confidence of coal resource existence and data density, the resources are further classified into three categories respectively: Measured, Indicated and Inferred. These were considered by the Qualified Person during the classification of the resources at the Ovoot Tolgoi Deposit.

As a consequence of material changes in some key assumptions underlying the analysis of its resources subsequent to the last detailed review of the project in 2016, particularly those relating to ongoing changes in coal market conditions in China, geologic analysis, optimized mining strategy and processing strategy, the Company has updated its resource and reserve estimate for the Ovoot Tolgoi Deposit.

The resource estimate presented in this MD&A is materially different from the previous estimate made in the 2016 Technical Report due to the following factors:

- The Geology Type classification has been re-categorized from "Severe" to "Complex", which led to a different requirement of spatial distribution of geological data and thus resource categorization according to GSC 88-21. Resource categories have been re-classified accordingly and this has resulted in the re-designation of the Measured Resource in the overall SGS resource portfolio.
- In-pit (surface) resources has been more conservatively constrained to the depth of 300m from the ground surface, compared to the depth of 350m used in the 2016 Technical Report.
- Underground resources have been re-established as resources and considered to be of reasonable prospect for eventual economic extraction due to recovering coal market conditions in China and Company's long-term plan for a thermal power plant near the mine site which is expected to generate substantial demand of thermal coal for electricity generation.
- A more conservative approach was adopted, compared to the last technical report in 2012 that contemplated potential economic extraction for the underground portion of the Ovoot Tolgoi Deposit (the "2012 Technical Report"), such that only underground resources to a depth of 500m were considered to be of reasonable prospects for eventual economic extraction.

Resources have been estimated for the Ovoot Tolgoi Deposit as of December 31, 2016, including Measured Resource of 201.9 million tonnes ("Mt"), Indicated Resource of 100.3 Mt and Inferred Resource of 89.0 Mt.

Resource categorization was completed on a Seam Group basis. The resource categorization also took into account the continuity and confidence in drill hole intersections along each section.

5. Properties continued

Operating Mines continued

Resources continued

The updated estimate of resources at the Ovoot Tolgoi Deposit is summarized in the following table.

Ovoot Tolgoi Deposit – Surface Resource Estimate				
			Resource (Mt)	
Coalfield	**Seam Group**	**Measured**	**Indicated**	**Inferred**
Sunrise Pit (depth <300m)	7	2.2	2.9	2.0
	6	3.4	4.8	4.2
	5U	39.6	20.5	22.6
	5L	18.2	4.1	1.0
	4	0.4	0.7	0.6
	subtotal	**63.8**	**33.0**	**30.4**
Sunset Pit (depth <300m)	11	0.1	–	–
	10	8.8	2.1	0.1
	9	17.8	3.4	0.2
	8	16.4	3.2	0.3
	5U	25.6	6.3	0.3
	5L	11.8	2.3	0.8
	subtotal	**80.5**	**17.3**	**1.7**
Grand Total		**144.3**	**50.3**	**32.1**

Totals may not add up due to rounding.

Ovoot Tolgoi Deposit – Underground Resource Estimate				
			Resource (Mt)	
Coalfield	**Seam Group**	**Measured**	**Indicated**	**Inferred**
Sunrise (depth 300m to 500m)	5U	2.0	4.9	13.1
	5L	6.0	12.0	25.0
	subtotal	**8.0**	**16.9**	**38.1**
Sunset (depth 300m to 500m)	10	3.0	1.9	–
	9	6.2	4.6	0.4
	8	6.9	3.8	2.2
	5U	27.9	14.9	3.4
	5L	5.6	7.9	12.8
	subtotal	**49.6**	**33.1**	**18.8**
Grand Total		**57.6**	**50.0**	**56.9**

Totals may not add up due to rounding.

5. Properties continued

Operating Mines continued

Resources continued

Resources have been estimated as of December 31, 2016 using the Minex™ models provided by SGS. The key assumptions used for the resource estimation are:

- Minimum coal thickness = 0.6m;
- Maximum coal parting = 0.3m;
- Surface resources were constrained to a depth of 300m, same as the pit design used in the 2012 Technical Report;
- Volumes were converted to tonnages using laboratory relative density analytical results converted to an estimated in-situ basis;
- Resources were constrained to the mining lease held by SGS only;
- Resource were estimated on an in-situ basis (i.e. as an in-situ tonnage and not adjusted for mining recovery);
- Resources were depleted by mined out tonnage; and
- Resources are estimated based on the survey data made available as of December 20, 2016 for the Sunrise and Sunset coalfields.

The updated resource estimate for the Ovoot Tolgoi Deposit was prepared for the Company by DMCL, which has been engaged to prepare a technical report in compliance with NI 43-101 reflecting the updated resource estimate, which the Company expects to file on SEDAR within 45 days of this MD&A.

Reserves

The Company previously reported 175.7 million tonnes of proven and probable reserves in respect of the Ovoot Tolgoi Deposit based on the 2012 Technical Report. Subsequently, the total resources estimated for the Ovoot Tolgoi Deposit in the 2016 Technical Report significantly decreased from the 2012 Technical Report principally due to the exclusion of previously estimated underground resources, which were assessed as not having a reasonable prospect for eventual economic extraction. In response to the declining coal prices and weak coal transaction conditions in China, the previously established underground resource at the Ovoot Tolgoi deposit was not considered to be reasonably economically viable in the 2016 Technical Report, significantly reducing the Company's reported resources, which, together with the reclassification of the Geology Type of the deposit from "Complex" to "Severe", eliminated the Company's mineable reserves that had previously been established for the Ovoot Tolgoi deposit.

In late 2016, the Company and DMCL engaged in a comprehensive review of all relevant information including technical data, mining strategy, pit optimization, mine design, production scheduling, coal processing strategy, sales strategy, coal prices and recovering coal transaction conditions, in order to prepare and update its resources and reserve estimates and prepare a new mine plan. This process resulted in re-estimation of reserves by DMCL which appears in the table below.

5. Properties continued

Operating Mines continued

Reserves continued

The reserve estimate presented below is materially different from the previous estimate made in the 2016 Technical Report due to the following factors:

- The Geology Type classification has been re-categorized from "Severe" to "Complex", which led to a different requirement of spatial distribution of geological data and thus resource categorization according to GSC 88-21. Resource categories were re-classified accordingly such that Indicated and Inferred Resources were reclassified as Measured and Indicated Resources respectively. Such resource reclassification further resulted in the fact that the overall resource estimation and classification could be used in mine planning in conformity with the industry practice and NI 43-101 requirements; and

- In-pit (surface) resources are more conservatively constrained to a depth of 300m from the ground surface, compared to a depth of 350m used in the 2016 Technical Report.

Ovoot Tolgoi Deposit – Reserve Estimate				
			Reserve (Mt)	
Pit	Seam Group	Proven	Probable	Total
Sunrise Pit	7	0.4	0.5	0.9
	6	1.7	1.4	3.1
	5U	29.3	6.3	35.6
	5L	12.4	1.7	14.1
	4	0.4	0.5	0.9
	subtotal	**44.3**	**10.3**	**54.6**
Sunset Pit	11	0.1	–	0.1
	10	5.0	0.6	5.6
	9	10.2	0.5	10.7
	8	10.4	0.5	10.9
	5U	21.1	1.8	22.9
	5L	8.6	0.9	9.5
	subtotal	**55.2**	**4.3**	**59.5**
Grand Total		**99.5**	**14.6**	**114.1**

Totals may not add up due to rounding.

The above estimate of Reserves at the Ovoot Tolgoi Deposit have been estimated as of December 31, 2016 based on the resource model provided by SGS. Measured and Indicated Resources are inclusive of those Mineral Resources modified to produce the Reserves, ie, Reserves are not additional to Resources.

The key assumptions used for the reserve estimation are:

- The reserve estimation used coal selling prices provided by an independent market consulting firm which was commissioned by the Company in December 2016 and subsequently confirmed as reasonable and appropriate by the qualified person responsible for this reserve estimate;

- Reserves do not include any Inferred Resources which have been treated as waste (i.e. their mining costs have been covered but no revenue has been assumed for the Inferred Resources);

- A recovery factor of 95% and a dilution factor of 2.5% have been applied in the Reserve estimate;

- The pit design (and thus Reserves) was designed to a depth of 300m below the original ground surface, which is same as the pit design used in the 2012 Technical Report;

5. Properties continued

Operating Mines continued

Reserves continued

- Reserves are constrained to the mining lease held by SGS only although the open pit limits will extend across the lease boundary into the adjacent lease held by Mongolyn Alt Corporation ("MAK"). SGS and MAK have an agreement in place that allows SGS to strip off the overburden in MAK's lease. Coal within the pits and within the MAK's lease has been treated as generating no revenue and having no associated cost whereas the waste within the pits and MAK's lease will be stripped off at SGS' cost; and

- Reserves are estimated to account for coal and waste that was mined as of December 31, 2016.

The updated reserve estimate for the Ovoot Tolgoi deposit was prepared by DMCL which has been engaged by the Company to prepare a technical report reflecting the updated reserve estimate in compliance with NI 43-101, which the Company expects to file on SEDAR within 45 days.

Mining Operations

Mining Method

The mining method employed at the Ovoot Tolgoi Deposit could be described as open pit terrace mining utilizing large scale hydraulic excavators and shovels and trucks. Terrace mining is utilized where coal seams dip steeply and operating machinery on the coal seam roof and floor is not possible, due to the steep seam dips. Terraces, or benches, are excavated along fixed horizontal horizons and these benches intersect both coal and waste. Coal and waste are mined separately on each bench with dozers being used, as needed, to push coal or waste down to the excavator for loading onto trucks. This mining method allows large scale open pit mining to occur productively in steeply dipping coal seam environments. All waste is dumped ex-pit, as the steep dips preclude in-pit dumping.

The open pit limits extend across the Ovoot Tolgoi Mining Licence boundary into the adjacent lease held by MAK. As described previously, the Company and MAK have a cooperation agreement in place to allow mining across the boundary, which stipulates that SGS is responsible for removal of MAK waste but MAK is responsible for mining of MAK coal. Accordingly, the current reserve estimate does not include any coal within the MAK lease that must be extracted as part of the Company mining operation. Therefore in the current mine plan, no revenue has been assumed for the MAK coal whereas costs have been assumed for stripping off the MAK waste.

Technical Report

The technical report for the Ovoot Tolgoi Deposit that is currently being prepared by DMCL will contain details of the new mine plan for Ovoot Tolgoi and will include information with respect to (i) processing and recovery operations, (ii) infrastructure, permitting and compliance, and (iii) capital and operating costs.

It is expected that the mine plan in the DMCL technical report will include a processing strategy marked by wet washing facilities comprised of a wet wash plant equipped with the customized jig washing circuit and deep de-watering equipment. It is further expected that such processing strategy will be multi-phased and expanded over time.

5. Properties continued

Mining Operations continued

Transportation Infrastructure

On August 2, 2011, the State Property Committee of Mongolia awarded the tender to construct a paved highway from the Ovoot Tolgoi Mine to the Shivee Khuren Border Crossing (the "Paved Highway") to consortium partners NTB LLC and SGS (together referred to as "RDCC LLC"). The Company has an indirect 40% shareholding in RDCC LLC through its Mongolian subsidiary SGS.

On October 26, 2011, RDCC LLC signed a concession agreement with the State Property Committee of Mongolia. RDCC LLC has the right to conclude a 17-year build, operate and transfer agreement under the Mongolian Law on Concessions.

On May 8, 2015, the commercial operation of the Paved Highway commenced. The Paved Highway has significantly increased the safety of coal transportation, reduced environmental impacts and improved efficiency and capacity of coal transportation. The current toll rate is set at MNT 900 per tonne of coal as compared to MNT 1,500 as stated in the signed concession agreement between RDCC LLC and the State Property Committee of Mongolia.

On September 17, 2015, the Invest Mongolia Agency signed an amendment to the concession agreement with RDCC LLC to extend the exclusive right of ownership to 30 years.

The Paved Highway has a carrying capacity in excess of 20 million tonnes of coal per year.

For the three months ended and the year ended December 31, 2016, RDCC LLC recognized toll fee revenue of $1.7 million (2015: $1.1 million) and $5.0 million (2015: $2.6 million), respectively.

Mining Equipment

The key elements of the currently commissioned mining fleet includes: two Liebherr 996 ($33m^3$ & $36m^3$) hydraulic excavators, three Liebherr R9250 ($15m^3$) hydraulic excavators, 23 MT4400AC (218 tonne capacity) haul trucks and three Terex TR100 (91 tonne capacity) haul trucks, together with various pieces of ancillary equipment.

Workforce

As at December 31, 2016, SGS employed 372 employees in Mongolia. Of the 372 employees, 44 are employed in the Ulaanbaatar office, 2 in outlying offices and 326 at the Ovoot Tolgoi Mine site. Of the 372 employees based in Mongolia, 371 (99%) are Mongolian nationals and of those, 184 (49%) are residents of the local Gurvantes, Dalanzadgad, Sevrei and Noyon Soums.

5. Properties continued

Development Projects and Exploration Program

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 (collectively, the "Soumber Deposit"). 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 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 25, 2013, the Company reported an updated NI 43-101 compliant independent resource estimate prepared by RPM. RPM estimated that the Soumber Deposit contains measured coal resources of 62.4 million tonnes, indicated coal resources of 110.3 million tonnes and inferred coal resources of 123.0 million tonnes as at January 10, 2013. Approximately 76% of the Soumber Deposit 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 available on SEDAR 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 seams exhibit potential coking coal characteristics.

On July 6, 2011, the Company announced that MRAM issued the Company a mining license pertaining to the Soumber Deposit. The 10,993ha mining license was granted for an initial term of 30 years with an option for two 20 year extensions. In addition to the existing mining license, the Company also held two exploration licenses (9443X and 9449X) pertaining to certain areas associated with the Soumber Deposit for which PMAs have been issued. In January 2016, these two exploration licenses were converted to mining licenses (MV-025436 and MV-020451) by MRAM.

A territory (Central, East Soumber and Biluut) covering the Soumber Deposit mining license area was designated by the provincial authorities as a special protected area (refer to section 7 "Regulatory Issues and Contingencies" for details of the status of the Soumber Deposit in respect of this designation by the provincial authorities).

Environmental baseline studies have been completed and general environmental impact assessments have been approved. The Company has delayed plans for a pre-feasibility study for the Soumber Deposit and intends to manage the feasibility planning and physical preparation of the Soumber Deposit having regard to ongoing market conditions, government requirements and the Company's available financial resources.

5. Properties continued

Development Projects and Exploration Program continued

Zag Suuj Deposit

The Zag Suuj Deposit, located approximately 150km east of the Ovoot Tolgoi Mine and approximately 45km north of the Mongolia-China border, lies within the administrative units of Noyon and Bayandalai Soums in the Umnugobi Aimag (South Gobi Province) (the "Zag Suuj Deposit").

Based on the exploration results to date, the coal occurrence at the Zag Suuj Deposit can be divided into four major seam groups. Each of the seam groups 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 Mine 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 five, indicating metallurgical properties; however, limited metallurgical testing has been undertaken to date.

On March 25, 2013, the Company reported an updated NI 43-101 compliant independent resource estimate for the Zag Suuj Deposit prepared by RPM. RPM estimated that the Zag Suuj Deposit contains indicated coal resources of 21.5 million tonnes and inferred coal resources of 84.0 million tonnes as at January 10, 2013. The entire Zag Suuj Deposit resource is located above 300metres ("m") 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 available on SEDAR 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 two exploration licenses pertaining to the Zag Suuj Deposit (13779X and 5267X) for which PMAs were issued on August 14, 2013 were converted to mining licenses (MV-020676 and MV-020675) by the MRAM in November 2016.

It is anticipated that coal from the Zag Suuj Deposit can be washed to produce a coking coal product or a coking coal blend product. Limited exploration activities are planned for the Zag Suuj Deposit in 2016. Exploration activities in 2017 will meet the requisite requirements under the Mongolian Minerals Law.

Ovoot Tolgoi Underground Deposit

The Ovoot Tolgoi Underground Deposit is contiguous to, and located directly below, the Ovoot Tolgoi Mine. As a result of the work performed by DMCL, resources have been re-installed in respect of the Ovoot Tolgoi Underground Deposit and is now considered to be of reasonable prospects for eventual economic extraction due to recovering coal market conditions in China and Company's long-term plan of fire-power plant near to the mine site which will require a substantial supply of thermal coal nearby.

Exploration Program

The Company continued to minimize evaluation and exploration expenditures during 2016 in order to preserve the Company's financial resources. The 2017 exploration program will be limited to ensuring that the Company meets the Mongolian Minerals Law requirements in respect of its mining and exploration licenses including those related to the Soumber Deposit and Zag Suuj Deposit.

6. Liquidity and Capital Resources

Liquidity and Capital Management

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.

Turquoise Hill Loan Facility

On May 25, 2014, the Company announced it obtained the TRQ Loan in the form of a $10 million revolving credit facility to meet its short term working capital requirements. The terms and conditions of this facility were filed on SEDAR (www.sedar.com) on June 2, 2014. The key commercial terms of the facility were: an original maturity date of August 30, 2014 (subsequently extended as described below); an interest rate of one month US dollar LIBOR Rate in effect plus 11% per annum; a commitment fee of 35% of interest rate payable quarterly in arrears on undrawn principal amount of facility and a front end fee of $0.1 million.

During 2014 to 2016, the due date of the TRQ Loan, was extended several times and the maximum amount of the facility was reduced to $3.8 million.

On May 16, 2016, the Company and Turquoise Hill entered into the May 2016 Deferral Agreement, whereby Turquoise Hill agreed to a limited deferral of repayment of all remaining amounts and obligations owing under the TRQ Loan to December 29, 2017 in accordance with the schedule of repayment set out below:

- The Company agreed to effect monthly repayments on the last business day of each month in an amount of (i) $0.15 million per month from May 2016 to April 2017; (ii) $0.2 million per month from May 2017 to December 2017 (the payments in (i) and (ii), the "Repayments"), at which time all remaining obligations will become due;
- In the event that the Company fails to make any one of the Repayments in its entirety on or before the dates set out above, then the Company shall be in automatic and irremediable default of the obligations thereunder and under the TRQ Loan, shall immediately and irremediably lose all benefits of the May 2016 Deferral Agreement, and all then outstanding obligations shall become immediately due and payable to Turquoise Hill; and
- Interest shall continue to accrue on all outstanding obligations at the 12-month US dollar LIBOR rate.

Unless otherwise agreed by Turquoise Hill, under certain circumstances, including the non-payment of interest amounts as the same become due, amounts outstanding under the TRQ Loan may be accelerated. Bankruptcy and insolvency events with respect to the Company or its material subsidiaries will result in an automatic acceleration of the indebtedness under the TRQ Loan. Subject to notice and cure periods, certain events of default under the TRQ Loan will result in acceleration of the indebtedness under such loan at the option of Turquoise Hill.

At December 31, 2016, the outstanding principal and accrued interest under this facility amounted to $2.2 million and $0.7 million, respectively (at December 31, 2015, the outstanding principal and accrued interest under the facility amounted to $3.4 million and $0.6 million, respectively).

To date, the Company has made all payments due under the May 2016 Deferral Letter Agreement.

Short-term bridge loan

On October 27, 2015, the Company executed a $10 million bridge loan agreement with an independent Asian based private equity fund. The interest rate is 8% per annum with interest payable upon the repayment of loan principal.

The Company repaid the first tranche of the short-term bridge loan with interest of $5.0 million up to August 11, 2016. During June and July 2016, the Company drew the second tranche of $5.0 million, of which $1.5 million has been matured in March 2017 and $3.5 million will mature in April 2017. In December 2016, $1.5 million was repaid for the short-term bridge loan and a further $1.8 million and $1.6 million was subsequently repaid in January 2017 and March 2017, respectively.

6. Liquidity and Capital Resources continued

Liquidity and Capital Management continued

Short-term bridge loan continued

As at December 31, 2016, the outstanding balance for the short-term bridge loan was $3.3 million (December 31, 2015: $4.9 million) and the Company owed accrued interest of $0.1 million (December 31, 2015: $0.1 million). A loan arrangement fee of 5% of the loan principal drawn was charged, totaling $0.3 million for the loans drawn during June and July 2016 and amortized throughout the loan term. For the year ended December 31, 2016, $0.2 million of loan arrangement fee was amortized (2015: nil).

Under certain circumstances, including the non-payment of interest amounts as the same become due, amounts outstanding under the short-term bridge loan may be accelerated. Bankruptcy and insolvency events with respect to the Company or its material subsidiaries will result in an automatic acceleration of the indebtedness under the short-term bridge loan. Subject to notice and cure periods, certain events of default under the short-term bridge loan will result in acceleration of the indebtedness under the short-term bridge loan at the option of the lender.

Bank loan

On May 6, 2016, the Company entered into a $2.0 million loan agreement with a Mongolian bank. The key commercial terms of the loan are as follows:

- Maturity on May 6, 2017;
- Interest rate of 15.8% per annum and payable monthly; and
- Certain items of property, plant and equipment were pledged which had a carrying value of $3.7 million as at December 31, 2016.

As at December 31, 2016, the outstanding balance for the bank loan was $2.0 million (2015: nil) and the Company owed accrued interest of $0.1 million (2015: nil).

Going concern considerations

The Company's consolidated financial statements have been prepared on a going concern basis which assumes that the Company will continue operating until at least December 31, 2017 and will be able to realize its assets and discharge its liabilities in the normal course of operations as they come due. However, in order to continue as a going concern, the Company must generate sufficient operating cash flows, secure additional capital or otherwise pursue a strategic restructuring, refinancing or other transactions to provide it with additional liquidity.

6. Liquidity and Capital Resources continued

Liquidity and Capital Management continued

Going concern considerations continued

Several adverse conditions and material uncertainties cast significant doubt upon the going concern assumption. The Company had a working capital deficiency (excess current liabilities over current assets) of $59.4 million as at December 31, 2016 compared to $42.3 million of working capital deficiency as at December 31, 2015. Included in the working capital deficiency at December 31, 2016 are significant obligations, which come due in the short-term, including the agreement to pay $19.7 million to CIC from January to May 2017, pursuant to the interest deferral agreement (refer to "CIC Convertible Debenture" of section 6). Although the Company has been in discussions with CIC for a further deferral, there can be no assurance that a favorable outcome can be reached.

Further, the trade and other payables of the Company have continued to accumulate due to liquidity constraints. The aging profile of trade and other payables has worsened as compared to December 31, 2015, as follows:

$ in thousands		As as December 31, 2016		2015
Less than 1 month	$	**14,640**	$	9,465
1 to 3 months		**2,493**		3,282
3 to 6 months		**2,648**		6,075
Over 6 months		**23,847**		12,095
Total trade and other payables	$	**43,628**	$	30,917

The Company may not be able to settle all trade and other payables on a timely basis while continuing postponement in settling the trade payables may impact the mining operations of the Company and result in potential lawsuits and/or bankruptcy proceedings being filed against the Company. No such lawsuits or proceedings are pending as at March 31, 2017.

The Company also has other current liabilities, which require settlement in the short-term, including: the remaining cash payments of $3.0 million due in connection with the Tax Penalty owing to the Government of Mongolia; the MTLLC settlement in the amount of $7.9 million, which is included in trade and other payables, due between March and June 2017; the $3.4 million balance of the short-term bridge loan due in April 2017 (repaid in January and March 2017); the $2.9 million balance of the TRQ Loan payable in monthly payments with the balance due in December 2017; and the bank loan of $2.0 million due in May 2017.

The Company is also party to a commercial arbitration in Hong Kong with First Concept, involving an $11.5 million amount received as a coal supply contract prepayment, whereby First Concept is seeking to recover its deposit rather than completing the contracted coal purchases. An arbitration decision, which would compel the Company to repay First Concept or alternatively, which would compel First Concept to take the coal, will impact the liquidity of the Company.

In order to address the continuing difficult coal market conditions in China, the Company has initiated a plan to change the existing product mix to higher value and higher margin outputs by washing certain grades of coal commencing in 2017 in order to produce more premium semi-soft coking coal and to initiate more processing of the lower grades of coal in order to reduce the ash content and improve the selling price and margins on its thermal coal product. The Company has also completed a new mine plan, which incorporates the coal washing and processing systems and contemplates significantly higher volumes of production in order to complement the Company's new product mix and sales volume targets. Such plans will involve the need for a significant level of stripping activities over the next two years and require certain capital expenditures to achieve the designed production outputs. Such expenditures will require the Company to seek additional financing in the form of finance leases, debt or equity. The Company has entered into an agreement for a finance lease on the new wash plant facility but will need financing to complete the thermal coal processing facilities.

6. Liquidity and Capital Resources continued

Liquidity and Capital Management continued

Going concern considerations continued

There is no guarantee that the Company will be able to successfully execute the measures mentioned above and secure other sources of financing. If it fails to do so, or is unable to secure additional capital or otherwise restructure or refinance its business in order to address its cash requirements through December 31, 2017, then the Company is unlikely to have sufficient capital resources or cash flows from mining operations in order to satisfy its current ongoing obligations and future contractual commitments. This could result in adjustments to the amounts and classifications of assets and liabilities in the Company's consolidated financial statements and such adjustments could be material.

Unless the Company acquires additional sources of financing and/or funding in the short term, the ability of the Company to continue as a going concern is threatened. If the Company is unable to continue as a going concern it may be forced to seek relief under applicable bankruptcy and insolvency legislation.

Continuing delay in securing additional financing could ultimately result in an event of default of the CIC Convertible Debenture, the TRQ Loan and the bank loan, which if not cured within applicable cure periods in accordance with the terms of respective instruments, may result in the principal amounts owing and all accrued and unpaid interest becoming immediately due and payable upon notice to the Company by CIC, Turquoise Hill and the lender of the bank loan, respectively.

Factors that impact the Company's liquidity are being closely monitored 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 and exploration and discretionary expenditures.

As at December 31, 2016, the Company's gearing ratio was 0.37 (2015: 0.33), which was calculated based on the Company's long term liabilities to total assets. As at December 31, 2016 and December 31, 2015, the Company is not subject to any externally imposed capital requirements.

As at March 31, 2017, the Company had $5.3 million of cash.

CIC Convertible Debenture

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% (6.4% payable semi-annually in cash and 1.6% payable annually in the Company's shares) with a maximum term of 30 years. The CIC Convertible Debenture is secured by a first ranking charge over the Company's assets and certain subsidiaries. The financing was used primarily to support the accelerated investment program in Mongolia and for working capital, repayment of debt, general and administrative expenses and other general corporate purposes.

On March 29, 2010, the Company exercised its right to call for the conversion of up to $250.0 million of the CIC Convertible Debenture into approximately 21.5 million shares at a conversion price of $11.64 (CAD$11.88). As at December 31, 2016, CIC owned, through its indirect wholly owned subsidiary, approximately 19.4% of the issued and outstanding common shares of the Company.

On July 13, 2016, the Company executed a deferral agreement with CIC which covered outstanding deferred cash interest obligations and associated costs of $18.8 million as of July 13, 2016 and the cash interest payment of $8.1 million due on November 19, 2016. Pursuant to the deferral agreement, the Company originally agreed to repay $1.3 to $1.4 million monthly from July to November 2016 and repay $20.7 million on December 19, 2016. In consideration for the deferred payments, the Company agreed to pay a deferral fee at a rate of 6.4% per annum to CIC.

In November 2016, the Company and CIC agreed to delay the share issuance portion of the interest settlement of $4 million, subsequently the shares of $4 million were issued to CIC on January 11, 2017.

6. Liquidity and Capital Resources continued

CIC Convertible Debenture continued

On December 29, 2016, the Company executed the December 2016 Deferral Agreement with CIC for a revised repayment schedule on the $20.7 million of cash interest and associated costs originally due on December 19, 2016 ("December 2016 Deferral Amounts"). The key repayment terms of the December 2016 Deferral Agreement are: (i) the Company is required to repay $6.8 million of the cash interest and associated deferral fee costs in five monthly amounts during the period from December 2016 to April 2017; and (ii) the Company is required to repay $14.3 million of cash interest and associated costs on May 19, 2017.

At any time before the December 2016 Deferral Amounts are fully repaid, the Company is required to consult with and obtain written consent from CIC prior to effecting a replacement or termination of either or both of its Chief Executive Officer and its Chief Financial Officer; otherwise this will constitute an event of default under the CIC Convertible Debenture, but CIC shall not withhold its consent if the board of directors proposes to replace either or both such officers with nominees selected by the Board, provided that the directors acted honestly and in good faith with a view to the best interests of the Company in the selection of the applicable replacements.

To date, the Company has made all payments due under the December 2016 Deferral Agreement.

Under certain conditions, including the non-payment of interest amounts as the same become due, amounts outstanding under the CIC Convertible Debenture may be accelerated. Bankruptcy and insolvency events with respect to the Company or its material subsidiaries will result in an automatic acceleration of the indebtedness under the CIC Convertible Debenture. Subject to notice and cure periods, certain events of default under the CIC Convertible Debenture will result in acceleration of the indebtedness under such debenture at the option of CIC. Such other events of default include, but are not limited to, non-payment, breach of warranty, non-performance of obligations under the CIC Convertible Debenture, default on other indebtedness and certain adverse judgments.

Cash Flow Highlights

	Year ended December 31,	
$ in thousands	**2016**	2015
Cash generated from/(used in) operating activities	**$ 2,761**	$ (10,014)
Cash used in investing activities	**(1,530)**	(8,572)
Cash generated from/(used in) financing activities	**(579)**	15,202
Effect of foreign exchange rate changes on cash	**(63)**	(28)
Increase/(decrease) in cash for the period	**589**	(3,412)
Cash balance, beginning of year	**377**	3,789
Cash balance, end of year	**$ 966**	$ 377

Cash generated from/(used in) Operating Activities

The Company generated $2.8 million of cash in operating activities in 2016 compared to $10.0 million being used in 2015. This is primarily due to the increase in coal sales during the year.

Cash used in Investing Activities

For 2016, the Company used $1.6 million of cash in investing activities compared to $8.6 million for 2015. In 2016, expenditures on property, plant and equipment totaled $2.8 million (2015: $8.4 million) and $1.3 million of dividend income was collected from RDCC LLC (2015: nil).

6. Liquidity and Capital Resources continued

Cash Flow Highlights continued

Cash generated from/(used in) Financing Activities

The cash used in financing activities is $0.6 million for 2016 which mainly related to the interest and arrangement fees paid. For 2015, $15.2 million was generated which primarily related to the net proceeds from the private placements of $10.2 million and the net proceeds obtained from the short-term bridge loan of $5.0 million.

Contractual Obligations and Guarantees

Day-to-day mining, expansionary and sustaining capital expenditures as well as administrative operations give rise to commitments for future minimum payments. As at December 31, 2016, the Company's operating and capital commitments were:

	As at December 31, 2016			
	Within 1 year	2-3 years	Over 3 years	Total
Capital expenditure commitments	$ 1,897	$ –	$ –	$ 1,897
Operating expenditure commitments	6,546	700	213	7,459
Commitments	$ 8,443	$ 700	$ 213	$ 9,356

Pursuant to an Investment and Collaboration Agreement dated April 2, 2016, the Company contracted with a third party to construct and operate a wash plant at the Ovoot Tolgoi mine site. Under the terms of the agreement the other party is responsible for all capital costs related to the construction of the facility and to operate the facility during the initial term of the contract, which is until 10 million tonnes of coal is washed. Upon reaching 10 million tonnes of coal washed, the ownership of the wash plant will pass to the Company. Payment for the coal washing will be Renminbi 25 per tonne covering a set amount per tonne for operating costs and a set amount per tonne as a reimbursement of the capital costs. As such, upon completion of the construction of the wash plant, it is expected that the agreement will be accounted for as a finance lease. Management is currently in discussions with the third party contractor to renegotiate certain terms of the contract prior to the commencement of commissioning.

Ovoot Tolgoi Mine Impairment Analysis

The Company determined that an indicator of impairment existed for its Ovoot Tolgoi Mine cash generating unit as at December 31, 2016. The impairment indicator was the uncertainty of future coal prices in China.

Therefore, the Company conducted an impairment test whereby the carrying value of the Company's Ovoot Tolgoi Mine cash generating unit was compared to its "fair value less costs of disposal" ("FVLCTD") using a discounted future cash flow valuation model. The Company's cash flow valuation model takes into consideration the latest available information to the Company, including but not limited to, sales price, sales volumes and washing assumptions, operating cost and life of mine coal production assumptions as at December 31, 2016. The Company's Ovoot Tolgoi Mine cash generating unit carrying value was $169.3 million as at December 31, 2016.

Key estimates and assumptions incorporated in the valuation model included the following:

- Coal resources and reserves as estimated by an independent third party engineering firm;
- Sales price estimates from an independent market consulting firm;
- Forecasted sales volumes in line with production levels as per the updated mine plan;
- Updated life-of-mine coal production, strip ratio, capital costs and operating costs;
- Coal washing to increase the volume of premium semi-soft coking coal sold;

6. Liquidity and Capital Resources continued

Ovoot Tolgoi Mine Impairment Analysis continued

- Coal processing to increase the grade and qualities of the thermal coal produced and sold; and
- A post-tax discount rate of 13.5% based on an analysis of the market, country and asset specific factors.

The impairment analysis did not result in the identification of an impairment loss or an impairment reversal and no charge or reversal was required as at December 31, 2016. The Company also conducted an impairment analysis in the prior year and an impairment loss of $76.7 million was charged to other operating expense for the year ended December 31, 2015. The Company believes that the estimates and assumptions incorporated in the impairment analysis are reasonable; however, the estimates and assumptions are subject to significant uncertainties and judgments.

Investment in RDCC LLC Impairment Analysis

At each reporting date, the Company reviews its investment in RDCC LLC to determine whether there are any indications of impairment. As at December 31, 2016, management of the Company determined that the current toll rate being lower than the rate per the concession agreement, constituted an impairment indicator. Therefore, the Company completed an impairment assessment for the investment in RDCC LLC whereby the carrying value of the investment was compared to its recoverable amount using assumptions consistent with those used at December 31, 2015. Management's impairment evaluation did not result in the identification or reversal of an impairment loss as at December 31, 2016.

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 values of the embedded derivatives within the CIC Convertible Debenture are 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.

	As at December 31,	
$ in thousands	**2016**	2015
Financial assets		
Loans-and-receivables		
Cash	**$ 966**	$ 377
Trade and other receivables	**19,434**	8,196
Total financial assets	**$ 20,400**	$ 8,573

6. Liquidity and Capital Resources continued

Financial Instruments continued

$ in thousands		As at December 31, 2016		2015
Financial liabilities				
Fair value through profit or loss				
Convertible debenture – embedded derivatives	**$**	**540**	$	757
Other-financial-liabilities				
Trade and other payables		**43,628**		30,917
Interest-bearing borrowings		**8,879**		8,905
Convertible debenture – debt host		**117,050**		107,902
Total financial liabilities	**$**	**170,797**	$	148,481

The net loss in 2016 and 2015 included the following amounts of unrealized loss and gain from the fair value adjustments to the embedded derivatives of the CIC Convertible Debenture which is classified as FVTPL:

$ in thousands		Three months ended December 31, 2016		2015		Year ended December 31, 2016		2015
Unrealized gain on embedded derivatives in CIC Convertible Debenture	**$**	**458**	$	379	**$**	**217**	$	1,077

7. Regulatory Issues and Contingencies

Governmental and Regulatory Investigations

In 2014, the Company was subject to investigations by Mongolia's Independent Authority Against Corruption (the "IAAC") regarding allegations of breaches of Mongolia's anti-corruption laws (the "Anti-Corruption Case"), and tax evasion and money laundering (the "Tax Evasion Case").

While the IAAC has not made any formal accusations against any current or former employee of the Company or the Company under the Anti-Corruption Case, administrative penalties were imposed on certain of the Company's Mongolian assets in connection with the investigation, including certain funds held in bank accounts in Mongolia totaling $1.2 million (the "Restricted Funds"). The Company has been informed that the Anti-Corruption Case has been suspended; however, it has not received formal notice that the investigation is completed.

With respect to the Tax Evasion Case, on December 30, 2014, the Capital City Prosecutor's Office (Ulaanbaatar, Mongolia) dismissed the allegations of money laundering as not having been proven during the investigation; however, proceedings in respect of tax evasion by former employees of the Company proceeded and culminated in February 2015, when the Company received the written verdict (the "Tax Verdict") of the Mongolian Second District Criminal Court. The Tax Verdict pronounced the three former employees of SGS guilty and declared SGS to be financially liable as a "civil defendant" for a penalty (the "Tax Penalty") of MNT35.3 billion (approximately $18.2 million on February 1, 2015). Following the refusal of the Supreme Court of Mongolia to hear the case on appeal in June 2015, the Tax Verdict entered into force. The Tax Verdict is, however, not immediately payable and enforceable against SGS absent further actions prescribed by the laws of Mongolia. However, the Company made a corresponding provision for the court case penalty of $18.0 million in the second quarter of 2015 given the Tax Verdict had entered into force.

On October 6, 2015, the Company was informed by its Mongolian banks (where the Restricted Funds were held) that they had received an official request from the Court Decision Implementing Agency of Mongolia ("CDIA") to transfer the Restricted Funds according to the court decision. $1.2 million was transferred to CDIA from the frozen bank accounts in October and November 2015.

7. Regulatory Issues and Contingencies continued

Governmental and Regulatory Investigations continued

Following the submission by the Company of various proposals to resolve the dispute giving rise to the Tax Verdict, in May 2016, the Resolution 258 of the Government of Mongolia was issued, which approved the Company's proposal to partially settle the Tax Penalty by way of certain cash payments in 2016 and 2017 and by the Company performing certain mining operations at the Tavan Tolgoi deposit on behalf of Erdenes. Subsequent to this Resolution, the Company made cash payments of $2.4 million during 2016 as a partial settlement of the Tax Penalty.

In compliance with the Resolution 258, in November 2016, the Company entered into an agreement with Erdenes under which the Company agreed to perform certain mining operations equivalent to MNT 20.3 billion (approximately $8.1 million) in the West Tsankhi section of the Tavan Tolgoi deposit during the period November 2016 to February 2017. As at December 31, 2016, the Company had performed mining operations consisting of drilling and blasting of rock mass, stripping and loading topsoil, selective excavation and loading coal, and creating overburden stockpiles at the Tavan Tolgoi deposit equivalent to MNT5.2 billion (approximately $2.1 million).

As of the date hereof the Company has completed the mining operations at the Tavan Tolgoi deposit equivalent to MNT20.3 billion (approximately $8.1million) as set out in the agreement with Erdenes.

The Company has provided $9.1 million for the court case penalty at December 31, 2016. The decrease from $18.0 million as at June 30, 2015 is as a result of subsequent transfers from frozen bank accounts of $1.2 million, additional cash payments by the Company in 2016 of $2.4 million, the provision of mining services at the Tavan Tolgoi deposit in 2016 of $2.1 million and the foreign exchange adjustments.

The Company is required to make further cash payments of $3.0 million in 2017 to complete repayment to the balance of the penalty owing.

As described above, the Company is working with the relevant authorities in Mongolia to resolve the dispute giving rise to the tax verdict in a manner that is appropriate having regard to the Company's limited financial resources and supportive of a positive environment for foreign investment in Mongolia. Should the Company fail to meet the terms of the agreed repayment plan and to receive a discharge of the judgment from the applicable Mongolian court, this may result in an event of default under the CIC Convertible Debenture and CIC would have the right to declare the full principal and accrued interest owing thereunder immediately due and payable. Such an event of default under the CIC Convertible Debenture or the Company's inability to pay the penalty could result in voluntary or involuntary proceedings involving the Company, including bankruptcy.

7. Regulatory Issues and Contingencies continued

Internal Investigations

Through its Audit Committee (comprised solely of independent directors), the Company conducted an internal investigation into possible breaches of law, internal corporate policies and codes of conduct arising from allegations raised in the context of investigations by Mongolian authorities. The former Chair of the Audit Committee also participated in a tripartite committee, comprised of the Audit Committee Chairs of the Company and Turquoise Hill and a representative of Rio Tinto plc., focused on the investigation of a number of those allegations, including possible violations of anti-corruption laws. The tripartite committee substantially completed the investigative stage of its activities during the third quarter of 2013. There have been no significant developments in respect of the internal investigations since the completion of the investigation phase during the third quarter of 2013.

The investigations referred to above could result in one or more Mongolian, Canadian, United States or other governmental or regulatory agencies taking civil or criminal action against the Company, its affiliates or its current or former employees. The likelihood or consequences of such an outcome are unclear at this time but could include financial or other penalties, which could be material, and which could have a material adverse effect on the Company.

The Company, through the Board and management, has taken a number of steps to address issues noted during the investigations and to focus on ongoing compliance by all employees with all applicable laws, internal corporate policies and codes of conduct, and with the Company's disclosure controls and procedures and internal controls over financial reporting.

In the opinion of management of the Company, at December 31, 2016 a provision for this matter is not required.

Mongolian IAAC Investigation

In the first quarter of 2013, the Company was subject to orders imposed by the IAAC which placed restrictions on certain of the Company's Mongolian assets. The orders were imposed on the Company in connection with the IAAC's investigations of the Company as described above under "Governmental and Regulatory Investigations" and continued to be enforced by the Mongolian State Investigation Office. The restrictions on the assets were reaffirmed in the Tax Verdict and form part of the Tax Penalty payable by the Company.

The orders related to certain items of operating equipment and infrastructure and the Company's Mongolian bank accounts ("Restricted Funds"). The orders related to the operating equipment and infrastructure restricts the sale of these items; however, the orders do not restrict the use of these items in the Company's mining activities. The orders related to the Company's Mongolian bank accounts restricted the use of in-country funds but did not have any material impact on the Company's activities. The Restricted Funds were transferred to the Court Decision Implementing Agency of Mongolia as partial payment of the Tax Verdict in October and November 2015. See "Governmental and Regulatory Investigations" above.

Following a review by the Company and its advisers, it is the Company's view that the orders placing restrictions on certain of the Company's Mongolian assets did not result in an event of default as defined under the terms of the CIC Convertible Debenture. However, the enforcement of the orders could ultimately result in an event of default of the Company's CIC Convertible Debenture, which if it remains uncured for ten business days, would result in the principal amount owing and all accrued and unpaid interest will become immediately due and payable upon notice to the Company by CIC.

7. Regulatory Issues and Contingencies continued

Class Action Lawsuit

In January, 2014, Siskinds LLP, a Canadian law firm, filed a class action (the "Class Action") against the Company, certain of its former senior officers and directors, and its former auditors, Deloitte LLP, in the Ontario Court in relation to the Company's restatement of consolidated financial statements as previously disclosed in the Company's public filings.

To commence and proceed with the Class Action, the plaintiff was required to bring a preliminary leave motion and to certify the Class Action as a class proceeding (the "Leave Motion"). The Ontario Court rendered its decision on the Leave Motion on November 5, 2015.

The Ontario Court dismissed the plaintiff's Leave Motion as against each of the former senior officers and directors of the Company named in the Class Action on the basis that the "large volume of compelling evidence" proved the defense of reasonable investigation on the balance of probabilities and provided the basis for dismissing the Leave Motion as against them.

However, the Ontario Court allowed the Ontario class action to proceed under Part XXIII.1 of the Ontario Securities Act, permitting the plaintiff to commence and proceed with an action against the Company in respect of alleged misrepresentations affecting trades in the secondary market for the Company's securities arising from the restatement. The Company initiated the Corporation's Appeal to appeal this portion of the decision of the Ontario Court.

On his part, the plaintiff initiated the Individual's Appeal whereby the plaintiff appealed that part of the November 5, 2015 Ontario Court decision dismissing the action against former officers and directors of the Company. The Individual's Appeal was brought as of right to the Ontario Court of Appeal.

By Order dated September 12, 2016, the Corporation Appeal was transferred to the Ontario Court of Appeal to be heard together with the Individuals' Appeal. The Corporation Appeal was perfected on October 25, 2016 in the Ontario Court of Appeal.

Both the Individuals' Appeal and the Corporation Appeal will now be verbally argued together. The appeals have been scheduled to be heard by the Ontario Court of Appeal in June 2017.

The Company disputes and is vigorously defending itself against the plaintiff's claims through independent Canadian litigation counsel retained by the Company and the other defendants for this purpose. Due to the inherent uncertainties of litigation, it is not possible to predict the final outcome of the Class Action or determine the amount of potential losses, if any. However, the Company has judged a provision for this matter at December 31, 2016 is not required.

Toll Wash Plant Agreement with Ejin Jinda

In 2011, the Company entered into an agreement with Ejin Jinda, a subsidiary of China Mongolia Coal Co. Ltd. to toll-wash coals from the Ovoot Tolgoi Mine. The agreement had a duration of five years from commencement of the contract and provides for an annual wet washing capacity of approximately 3.5 million tonnes of input coal.

Under the original agreement with Ejin Jinda, which required the commercial operation of the wet washing facility to commence on October 1, 2011, the additional fees payable by the Company under the wet washing contract would have been $18.5 million. At each reporting date, the Company assesses the agreement with Ejin Jinda and has determined it is not probable that these $18.5 million will be required to be paid. Accordingly, the Company has determined a provision for this matter at December 31, 2016 is not required.

7. Regulatory Issues and Contingencies continued

Mining Prohibition in Specified Areas Law

In July 2009, Mongolia promulgated the Law on Prohibiting Mineral Exploration and Extraction Near Water Sources, Protected Areas and Forests (the "Mining Prohibition in Specified Areas Law"). Pursuant to the Mining Prohibition in Specified Areas Law, the Government of Mongolia has defined the boundaries of certain areas in which exploration and mining is purportedly prohibited. A list of licenses has been prepared that overlap with the prohibited areas described in the law based on information submitted by water authority agencies, forest authority agencies and local authorities for submission to the Government of Mongolia.

In order to address the issues facing its implementation, in February, 2015 the Parliament of Mongolia adopted an amendment to the Law on Implementation of the Mining Prohibition in Specified Areas Law (the "Amended Law on Implementation"). The Amended Law on Implementation provides an opportunity for license holders covered within the scope of application of the Mining Prohibition in Specified Areas Law to continue their mining operations subject to advance placement of funds to cover 100% of the future environmental rehabilitation costs. A model contract and a specific Government regulation on this requirement will be adopted by the Government. The license holders must also apply within 3 months after the amendment to the Law on Implementation comes into effect for permission to MRAM to resume activities. The Company considered the development projects may be affected, but not the operating mines. The Company submitted its application with respect to its mining licenses before the deadline set on June 16, 2015 but has not yet received any communication from MRAM on the status of its application.

Pursuant to the Mongolian Law "To prohibit mineral exploration and mining operations at headwaters of rivers, water protection zones and forested areas", the government administrative agency has notified the Company that special license area 12726A is partly overlapping with a water reservoir. The Company has inspected the area together with the Cadastral Division of the Mineral Resource Authority as well as through the cadastral registration system of the Ministry of Environment, it is determined that 29 hectares of Sukhait Bulag is partly overlapping with a water reservoir, of which has been partly handed over. (Resolution No.6/7522 issued on September 29, 2015 by the Head of Cadastral Division of the Mineral Resource Authority)

In accordance with Article 22.3 of Law of Mongolia on Water, 5,602.96 hectares of land, including Sukhaityn Bulag, Uvur Zadgai, and Zuun Shand pertaining to exploration license 9443X, which was converted to mining license MV-0125436 in January 2016, is overlapping with protected area boundary. It has been officially handed over to the local administration. (Resolution No.688 issued on September 24, 2015 by the Head of Cadastral Division of the Mineral Resource Authority) In connection with the nullification of Annex 2 of the government order No.194 "On determining boundary" issued on June 5, 2012, area around the water reservoir located at MV-016869 license area and Soumber exploration license 9449X, which was converted to mining license MV-020451 in January 2016, has been annulled from the Specified Area Law.

Therefore, mining license 12726A and MV-016869 and exploration licenses 9443X, 9449X were removed from the list of licenses that overlaps with the prohibited areas described in the law.

There has been limited development of the law during 2016 while two exploration licenses of the Company (13779X and 5267X) were converted to mining licenses (MV-020676 and MV-020675) in November 2016. The Company will continue to monitor the developments and ensure that it follows the necessary steps in the Amended Law on Implementation to secure its operations and licenses and is fully compliant with Mongolian law.

7. Regulatory Issues and Contingencies continued

Special Needs Territory in Umnugobi

On February 13, 2015, the entire Soumber mining license and a portion of SGS' exploration license No.9443X (9443X was converted to mining license MV-025436 in January 2016) (the "License Areas") were included into a special protected area (to be further referred as Special Needs Territory, "SNT") newly set up by the Umnugobi Aimag's Civil Representatives Khural (the "CRKh") to establish a strict regime on the protection of natural environment and prohibit mining activities in the territory of the SNT.

On July 8, 2015, SGS and the Chairman of the CRKh, in his capacity as the respondent's representative, reached an agreement (the "Amicable Resolution Agreement") to exclude the License Areas from the territory of the SNT in full, subject to confirmation of the Amicable Resolution Agreement by the session of the CRKh. The parties formally submitted the Amicable Resolution Agreement to the appointed judge of the Administrative Court for her approval and requested a dismissal of the case in accordance with the Law of Mongolia on Administrative Court Procedure. On July 10, 2015, the judge issued her order approving the Amicable Resolution Agreement and dismissing the case, while reaffirming the obligation of CRKh to take necessary actions at its next session to exclude the License Areas from the SNT and register the new map of the SNT with the relevant authorities. Mining activities at the Soumber property cannot proceed until the License Areas are removed from the SNT.

On June 29, 2016, the Mongolian Parliament and CRKh election was held. As a result, the Company is aware that additional action may be taken in respect of the SNT; however, the Company has not yet received any indication on the timing of the next session of the CRKh.

Commercial Arbitration in Hong Kong

On June 24, 2015, First Concept served a notice of arbitration (the "Notice") on SGS in respect of a coal supply agreement dated May 19, 2014 as amended on June 27, 2014 (the "Coal Supply Agreement") for a total consideration of $11.5 million. The arbitral proceedings (the "Arbitration") are deemed to have commenced on June 24, 2015, as the date when the respondent received the Notice.

The Company firmly rejects the allegations of First Concept in the Notice as lacking any merit. The Arbitration was held in the fourth quarter of 2016 and the decision is not expected until the second quarter of 2017.

There can be no assurance, however, that the Company will prevail in the Arbitration. Should SGS be unsuccessful in the Arbitration, the Company may not be able to re-pay the sum of $11.5 million. In such case, this may result in an event of default under the CIC Convertible Debenture and CIC would have the right to declare the full principal and accrued interest owing thereunder immediately due and payable. Such an event of default under the CIC Convertible Debenture or the Company's inability to re-pay the sum of $11.5 million to First Concept could result in voluntary or involuntary proceedings involving the Company (including bankruptcy).

Settlement of Claim by Former Chief Executive Officer

On June 30, 2015, the Company was served with a Notice of Civil Claim filed by the Company's former President and Chief Executive Officer, Mr. Molyneux, in the British Columbia Supreme Court, Canada. Mr. Molyneux acted as the Company's President (from April 2009) and Chief Executive Officer (from October 2009) until September 2012, when the Company terminated his employment. The claim, seeking damages in excess of $1 million, related to alleged breaches of Mr. Molyneux's employment agreement by the Company. In addition to the Company, Turquoise Hill, the Company's largest shareholder at the time of Mr. Molyneux's employment, was also named as a defendant in the claim. The Company filed a response to civil claim and a counterclaim in September 2015.

7. Regulatory Issues and Contingencies continued

Settlement of Claim by Former Chief Executive Officer continued

Mr. Molyneux's claim, and the counterclaim by the Company, has been settled by a payment by the Company to Mr. Molyneux of the sum of $0.29 million, without admission of liability by either party. As a term of the settlement, the Company and Mr. Molyneux executed mutual general releases, and the action and counterclaim were dismissed as against all parties by consent without court costs payable to any party, effective on November 25, 2016.

Settlement of Lawsuit Notice from a Former Fuel Supplier

On January 20, 2017, the Company announced that SGS had received a lawsuit notice from the DC Court in relation to a claim from MTLLC, a former fuel supplier of SGS, for MNT22.2 billion (approximately $8.9 million) consisting of MNT14.6 billion (approximately $5.8 million) of outstanding fuel supply payments and MNT7.6 billion (approximately $3.1 million) of late payment penalties and associated interest costs.

SGS disputed the amount claimed by MTLLC in the proceedings before the DC Court and filed an application with the DC Court to dismiss the litigation, on the basis that the contract required an arbitration process prior to the initiation of court proceedings. On January 25, 2017, the Company announced that the DC Court had dismissed the litigation pending the arbitration process.

Following SGS' successful challenge to the authority of the DC Court to hear the matter, the Company signed a settlement agreement with MTLLC on February 10, 2017 pursuant to which the outstanding amount of $7.9 million will be settled in equal monthly installments of $2.0 million from March 2017 to June 2017.

8. Environment

The Company is subject to the Environmental Protection Law of Mongolia ("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 the 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.

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 management plan (including reclamation measures) in co-operation with the Ministry of Environment, Green Development and Tourism, which should take into account the results of the environmental impact assessment. The Company received approval of its detailed Environmental Impact Assessment and Environmental Management Plan from the Mongolian Ministry of Environment for the mining operation at the Ovoot Tolgoi Mine in 2007 and renewed in 2016.

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.

8. Environment continued

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. In accordance with new provisions specified in Mongolian laws and regulations, in 2014 the Company developed a protection strategy jointly with professional organization. This strategic plan can serve as a policy document directed to protection of biological diversity, ecosystem balance and its preservation; and support species dwelling nearby the Ovoot Tolgoi mine area.

The Board maintains a Health, Environment, Safety and Social Responsibility Committee, which is composed of independent and executive 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 Health, Environment, Safety and Social Responsibility Committee also reviews any incidents that may occur and provides guidance on how to prevent any recurrences.

9. 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 an equity incentive plan to incentivize directors and eligible employees. Details of the plan are set out in note 25 of the Company's consolidated financial statements for the year ended December 31, 2016.

10. 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 31, 2017, 272.6 million common shares were issued and outstanding. There are also incentive share options outstanding to acquire 1.9 million unissued common shares with exercise prices ranging from CAD$0.25 to CAD$6.16. There are no preferred shares outstanding.

On April 15, 2016, Novel Sunrise entered into an Option Agreement (the "Option Agreement") with "Voyage Wisdom, a private company owned by Messrs. Ningqiao Li, Aminbuhe and Yulan Guo, each of whom are members of management (collectively, the "VWL Shareholders"), pursuant to which Novel Sunrise granted Voyage Wisdom an option to purchase from Novel Sunrise (the "Call Option"), and Voyage Wisdom granted Novel Sunrise an option to sell to Voyage Wisdom (the "Put Option"), 25.8 million common shares of the Company owned by Novel Sunrise, for a total purchase price of $24 million, payable in cash.

On January 11, 2017, Novel Sunrise reported that the Call Option was exercised effective as at December 31, 2016 and as a result 25.8 million common shares of the Company were transferred to Voyage Wisdom from Novel Sunrise for $24 million.

As at March 31, 2017, CIC holds a total of 64.8 million Common Shares representing approximately 23.8% of the issued and outstanding Common Shares.

10. Outstanding Share Data continued

As at March 31, 2017, Novel Sunrise holds a total of approximately 46.4 million Common Shares representing approximately 17.0% of the issued and outstanding Common Shares.

As at March 31, 2017, Voyage Wisdom holds a total of approximately 25.8 million Common Shares representing approximately 9.5% of the issued and outstanding Common Shares.

11. Disclosure Controls and Procedures and Internal Controls Over Financial Reporting ("ICFR")

Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted by it under securities legislation is recorded, processed, summarized and reported within the time periods specified in the securities legislation and include controls and procedures designed to ensure that information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted under securities legislation is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Management, including the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures. As of December 31, 2016, Chief Executive Officer and Chief Financial Officer have each concluded that the Company's disclosure controls and procedures, as defined in NI 52-109 – Certification of Disclosure in Issuer's Annual and Interim Filings, are effective to achieve the purpose for which they have been designed. 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.

Management assessed the effectiveness of internal controls over financial reporting using the Internal Control – Updated Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that the Company's internal controls over financial reporting were effective as of December 31, 2016.

There has been no significant 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.

12. 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 and judgments 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 Company's consolidated financial statements for the year ended December 31, 2016. Information about judgments and estimates in applying accounting policies that have the most significant effect on the amounts recognized in the consolidated financial statements are as follows:

Liquidity and Going Concern Assumption

In the determination of the Company's ability to meet its ongoing obligations and future contractual commitments, management relies on the Company's 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. The key inputs used by the Company in this process include forecasted capital deployment, results from operations, results from the exploration and development of its properties and general industry conditions as well as the expected timing of payments of suppliers and the repayment of debt and other financial liabilities.

While the Company intends to secure additional sources of financing as soon as possible, a continued delay in securing additional financing could ultimately result in an event of default of the CIC Convertible Debenture, the TRQ Loan and the bank loan, which if not cured within applicable cure periods in accordance with the terms of such instruments, may result in the principal amounts owing and all accrued and unpaid interest becoming immediately due and payable upon notice to the Company by CIC, Turquoise Hill and the lender of the bank loan, respectively.

Valuation of embedded derivatives

The embedded derivatives in the Company's 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.

The key inputs used by the Company in its Monte Carlo simulation are further disclosed in Note 22.2 and Note 22.3 of the Company's consolidated financial statements for the year ended December 31, 2016. Changes in the inputs to the valuation model could impact the carrying value of the embedded derivatives in the convertible debenture and the amount of unrealized gains or losses recognized in profit or loss.

Review of Carrying Value of assets and impairment charges

In the determination of carrying values and impairment charges, management of the Company reviews the recoverable amount (the higher of the fair value less costs of disposal or the value in use) in the case of non-financial assets and objective evidence indicating impairment in the case of financial assets. These determinations and their individual assumptions require that management make a decision based on the best available information at each reporting period. Changes in these assumptions may alter the results of non-financial asset and financial asset impairment testing, impairment charges recognized in profit or loss and the resulting carrying amounts of assets.

Ovoot Tolgoi Mine Cash Generating Unit

See section 6 "Liquidity and Capital Resources – Ovoot Tolgoi Mine Impairment Analysis" for further analysis of the impairment test performed as at December 31, 2016.

12. Critical Accounting Estimates and Judgments continued

Review of Carrying Value of assets and impairment charges continued

Investment in RDCC LLC

See section 6 "Liquidity and Capital Resources – Investment in RDCC LLC Impairment Analysis" for further analysis of the impairment test performed as at December 31, 2016.

Estimated Resources

The Company estimates its mineral resources based on information compiled by appropriately qualified persons relating to the geological data on the size, depth and shape of the ore body, and requires complex geological judgments to interpret the data. Changes in resource estimates may impact the carrying value of mining interests, mine restoration provisions, recognition of deferred tax assets, and depreciation and amortization charges.

Estimated Recoverable Reserves

Reserve 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 estimates and assumptions with respect to coal prices, operating costs, mine plan and life, coal quality and recovery, foreign currency exchange rates and inflation rates. Reserve estimates are made by qualified persons, but will be impacted by changes in the above estimates and assumptions.

Estimated recoverable reserves are used to determine the depletion of mineral properties, in accounting for deferred production stripping costs, in performing impairment testing and for forecasting the timing of the payment of decommissioning, restoration and similar costs. Therefore, changes in the estimates and assumptions used to determine recoverable reserves could impact the carrying value of assets, depletion expense and impairment charges recognized in profit or loss and the carrying value of the decommissioning, restoration and similar liabilities.

Useful lives and depreciation rates for property, plant and equipment

Depreciation expense is allocated based on estimated property, plant and equipment useful lives and depreciation rates except the mineral properties are depreciated on unit-of product basis based on proven and probable reserves. Therefore, changes in the useful life or depreciation rates from the initial estimate could impact the carrying value of property, plant and equipment and an adjustment would be recognized in profit or loss.

13. Recent Accounting Pronouncements

The standards that are issued up to the date of issuance of the Company's financial statements, but were not effective during the year ended December 31, 2016, are disclosed below. The Company intends to adopt these standards, if applicable, when they become effective.

IFRS 9	Financial Instruments [(i)]
IFRS 15	Revenue from Contracts with Customers [(i)]
IFRS 16	Leases [(ii)]

(i) Effective for annual periods beginning on or after January 1, 2018
(ii) Effective for annual periods beginning on or after January 1, 2019

IFRS 9, Financial Instruments ("IFRS 9") – classification and measurement, addresses the classification, measurement and derecognition of financial assets and financial liabilities, introduces new rules for hedge accounting and a new impairment model for financial assets. While the Company has yet to undertake a detailed assessment of the classification and measurement of financial assets and liabilities, it is not expected that the new guidance to have a significant impact on the classification and measurement of its financial assets and liabilities.

The new impairment model requires the recognition of impairment provisions based on expected credit losses ("ECL") rather than only incurred credit losses as is the case under IAS 39. It applies to financial assets classified at amortised cost. While the Company has not yet undertaken a detailed assessment of how its impairment provisions would be affected by the new model, it may result in an earlier recognition of credit losses.

The new standard also introduces expanded disclosure requirements and changes in presentation. These are expected to change the nature and extent of the Company's disclosures about its financial instruments particularly in the year of the adoption of the new standard.

The standard is effective for accounting periods beginning on or after January 1, 2018. Early adoption is permitted.

13. Recent Accounting Pronouncements continued

IFRS 15, Revenue from Contracts with Customers ("IFRS 15"), deals with revenue recognition and establishes principles for reporting useful information to users of financial statements about the nature, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Revenue is recognized when a customer obtains control of a good or service and thus has the ability to direct the use and obtain the benefits from the good or service. The standard replaces IAS 18, Revenue, and IAS 11, Construction Contracts, and related interpretations. The standard is effective for annual periods beginning on or after January 1, 2018 and earlier application is permitted. The Company has yet to assess IFRS 15's impact on its financial statements.

IFRS 16, Leases ("IFRS 16"), on January 13, 2016 the IASB issued IFRS 16, according to which, all leases will be recognized on the balance sheet, as the distinction between operating and finance leases is removed. Under the new standard, an asset (the right to use the leased item) and a financial liability to pay rentals are recognized. The only exceptions are short-term and low-value leases.

The standard will affect primarily the accounting for the Company's operating leases. As at the reporting date, the Company has non-cancellable operating lease commitments of $7.5 million. However, the Company has not yet determined to what extent these commitments will result in the recognition of an asset and a liability for future payments and how this will affect the Company's profit and classification of cash flows. Some of the commitments may be covered by the exception for short-term and low-value leases and some commitments may relate to arrangements that will not qualify as leases under IFRS 16.

The standard is effective for annual periods beginning on or after January 1, 2019.

There are no other IFRS or IFRIC interpretations with future effective dates that are expected to have a material impact on the Company.

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 the Company's ability to continue as a going concern; (ii) risks relating to the economic operation of the Company's Ovoot Tolgoi Project; (iii) risks relating to the Company's other projects in Mongolia; and (iv) risks relating to its business and industry. 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 Ability to Continue as a Going Concern

Unless the Company acquires additional sources of financing and/or funding in the short term, the ability of the Company to continue as a going concern is threatened

Several adverse conditions and material uncertainties cast significant doubt upon the going concern assumption contained in the Company's financial statements. The Company had limited cash of $1.0 million at December 31, 2016 and anticipates the situation faced by the Company will remain challenging in 2017 which will continue to impact the Company's margins and liquidity. The Company's consolidated financial statements have been prepared on a going concern basis which assumes that the Company will continue operating until at least December 31, 2017 and will be able to realize its assets and discharge its liabilities in the normal course of operations as they come due. However, in order to continue as a going concern, the Company must generate sufficient operating cash flows, secure additional capital or otherwise pursue a strategic restructuring, refinancing or other transactions to provide it with additional liquidity.

14. Risk Factors continued

Risks Relating to the Company's Ability to Continue as a Going Concern continued

Unless the Company acquires additional sources of financing and/or funding in the short term, the ability of the Company to continue as a going concern is threatened continued

The Company has enhanced its business plan, in which, in addition to minimizing uncommitted capital expenditures, securing additional financing and longer term coal offtake agreements by building direct sales relationships with end customers so as to improve sales volumes, the Company has been negotiating with key vendors to lengthen the credit terms and extend the payable turnover cycle. Further, the Company has been exploring the utilization of trade financing in order to speed up the receivable collection cycle.

The measures mentioned above are intended to allow the Company to ramp up production to capacity, meet existing as well as upcoming trade and other payables obligations and the interest due under the CIC Convertible Debenture, the TRQ Loan and the bank loan, to meet its obligations as they fall due and achieve its business objectives in 2017.

These obligations include the tax penalty due to the Government of Mongolia and the potential refund to First Concept and MTLLC settlement. However, there is no guarantee that the Company will be able to successfully execute the measures mentioned above and secure other sources of financing. If it fails to do so, or is unable to secure additional capital or otherwise restructure or refinance its business in order to address its cash requirements through December 31, 2017, then the Company is unlikely to have sufficient capital resources or cash flows from mining operations in order to satisfy its ongoing obligations and future contractual commitments, including the cash interest payments due under the CIC Convertible Debenture, the TRQ Loan and the bank loan. Unless the Company acquires additional sources of financing and/or funding in the short term, the ability of the Company to continue as a going concern is threatened. If the Company is unable to continue as a going concern it may be forced to seek relief under applicable bankruptcy and insolvency legislation. This could result in adjustments to the amounts and classifications of assets and liabilities in the Company's consolidated financial statements and such adjustments could be material.

Continuing delay in securing additional financing could ultimately result in an event of default of the CIC Convertible Debenture, TRQ Loan and the bank loan, which if not cured within applicable cure periods in accordance with the terms of respective instruments, may result in the principal amounts owing and all accrued and unpaid interest becoming immediately due and payable upon notice to the Company by CIC, Turquoise Hill and the lender of the bank loan, respectively.

Factors that impact the Company's liquidity are being closely monitored 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 and exploration and discretionary expenditures.

If the Company is unable to continue as a going concern, it would likely need to seek relief under applicable bankruptcy and insolvency legislation, which may negatively affect the price and volatility of the Common Shares and any investment in such shares could suffer a significant decline or total loss in value.

14. Risk Factors continued

Risks Relating to the Company's Ability to Continue as a Going Concern continued

If the Tax Verdict shall become immediately payable and enforceable, the Company will likely not have sufficient cash resources to satisfy the penalty imposed thereunder.

With the refusal by the Supreme Court to hear the case on appeal, the Tax Verdict has entered into force. The Tax Verdict is, however, not immediately payable and enforceable against SGS absent further actions prescribed by the laws of Mongolia. In particular, SGS has not received a copy of the bailiff's resolution on execution of the Tax Verdict, as required under the Law of Mongolia on Execution of Court Decisions in order for any judgment execution process to happen. However, the Company made a corresponding provision for the court case penalty of $18.0 million in the second quarter of 2015 given the Tax Verdict has entered into force. The Company has provided $9.1 million for the court case penalty at December 31, 2016. The decrease from $18.0 million as at June 30, 2015 is as a result of subsequent transfers from frozen bank accounts of $1.2 million, additional cash payments by the Company in 2016 of $2.4 million, the provision of mining services at the Tavan Tolgoi deposit in 2016 of $2.1 million and foreign exchange adjustments.

As of the date hereof the Company has completed the mining operations at the Tavan Tolgoi deposit equivalent to MNT 20.3 billion (approximately $8.1million) as set out in the agreement with Erdenes.

The Company is required to make further cash payments of $3.0 million in 2017 to complete repayment to the balance of the penalty owing.

If the Tax Verdict is enforceable against SGS and the balance owing under the Tax Penalty become immediately payable, neither SGS nor the Company on its behalf is likely to have sufficient cash resources to satisfy such penalty. In such circumstances, all of the assets of SGS may become subject of seizure by Mongolian authorities in the enforcement of the Tax Penalty. Any enforcement of the Tax Penalty would likely impair the Company's ability to continue as a going concern and the Company would likely need to seek relief under applicable bankruptcy and insolvency legislation, which may negatively affect the price and volatility of the Common Shares and any investment in such shares could suffer a significant decline or total loss in value.

For a description of the Tax Penalty, Tax Verdict, the Appeal Verdict and Former Employees and matters relating thereto, refer to "REGULATORY ISSUES AND CONTINGENCIES – Regulatory Issues – *Governmental and Regulatory Issues*" in this MD&A.

If an event of default occurs under the CIC Convertible Debenture, CIC has the right to accelerate amounts owing thereunder.

With the exception of an insolvency event, if an event of default occurs under the CIC Convertible Debenture, and such event of default has not been cured or waived, the principal amount owing and all accrued and unpaid interest will become immediately due and payable upon notice to the Company by CIC which would have a material adverse effect on the business and operations of the Company.

If an insolvency event occurs under the CIC Convertible Debenture, the principal amount owing and all accrued and unpaid interest will become immediately due and payable without the necessity for notice to the Company by CIC, which would have a material adverse effect on the business and operations of the Company.

14. Risk Factors continued

Risks Relating to the Company's Ability to Continue as a Going Concern continued

If the Company is unable to continue as a going concern it may be forced to seek relief under applicable bankruptcy and insolvency legislation.

If the Company seeks relief under applicable bankruptcy and insolvency legislation, its business and operations will be subject to certain risks, including but not limited to, the following:

- An insolvency filing by or against the Company will cause an event of default under the CIC Convertible Debenture (see Risk Factor above entitled "If an event of default occurs under the CIC Convertible Debenture, CIC has the right to accelerate amounts owing thereunder" in this MD&A);
- An insolvency filing by or against the Company may adversely affect its business prospects, including its ability to continue to obtain and maintain the contracts necessary to operate its business on competitive terms;
- There can be no assurance as to the Company's ability to maintain or obtain sufficient financing sources for operations or to fund any reorganization plan and meet future obligations;
- There can be no assurance that the Company will be able to successfully develop, prosecute, confirm and consummate one or more plans of reorganization that are acceptable to the applicable courts and its creditors, equity holders and other parties in interest; and
- The value of the Common Shares could be reduced to zero as result of an insolvency filing.

Due to the inherent uncertainties of litigation, it is not possible to predict the final outcome of the Class Action or determine the amount of any potential losses, if any.

The Company applied for and was granted leave to bring the Corporation Appeal, whereby the Company is appealing the Ontario Court's decision to grant the plaintiff permission to commence an action claiming damages under the Ontario Securities Act with respect to the Company's restatement of financial statements as previously disclosed in the Company's public filings. The plaintiff has also initiated the Individual's Appeal, whereby the plaintiff is appealing the portion of the November 5, 2015 Ontario Court decision that dismissed the action against former officers and directors of the Company.

By Order dated September 12, 2016, the Corporation Appeal was transferred to the Ontario Court of Appeal to be heard together with the Individuals' Appeal. The Corporation Appeal was perfected on October 25, 2016 in the Court of Appeal.

Both the Individuals' Appeal and the Corporation Appeal will now be verbally argued together. The appeals are scheduled to be heard by the Ontario Court of Appeal in June 2017.

The Company disputes and will vigorously defend itself against these claims through independent Canadian litigation counsel retained by the Company and the other defendants for this purpose. Due to the inherent uncertainties of litigation, it is not possible to predict the final outcome of the Class Action or determine the amount of any potential losses, if any.

In the event the Company incurs any liability in connection with the Class Action, it maintains insurance with respect thereto. While the Company believes that such insurance coverage is in an amount that would be sufficient to cover any amounts the Company may be required or determines to pay with respect thereto, there can be no assurance that such coverage will be adequate to do so, and, if so, any amounts not so covered would be required to be paid by the Company. The Company's ability to continue as a going concern will be impacted to the extent it is required to pay any amounts in connection with the Class Action.

14. Risk Factors continued

Risks Relating to the Economic Operation of the Company's Ovoot Tolgoi Project

There can be no assurance that the updated mine plan developed for the Ovoot Tolgoi Mine will ultimately be viable or profitable due to the inherent operational risks

As a result of work performed by DMCL, the Company increased its estimate of total resources at the Ovoot Tolgoi deposit from those described in the 2016 Technical Report and has declared reserves for the Ovoot Tolgoi deposit. In addition, DMCL is in the process of finalizing an updated mine plan for the Ovoot Tolgoi Mine on the basis of these updated resource and reserve estimates. Notwithstanding the declaration of reserves, there are number of factors that could prevent the Company from fully executing on the mine plan and include, but are not limited to, the following:

- Transition to contract mining and if the Company is able to negotiate a contract with applicable contractors at rates that justify the transition;
- Ability to generate sufficient sales volumes at economical realized prices;
- Water supply to the mine site to permit full operation of a wet washing plant;
- Achieving satisfactory yields from wet washing operations; and
- Successful conversion of resources into reserves during the life of mine.

Risks Relating to the Company's Projects in Mongolia

In addition to the Tax Verdict, the Company is subject to continuing governmental, regulatory and internal investigations, the outcome of which is unclear at this time but could have a material adverse effect on the Company.

In addition to the Tax Verdict, the Company is subject to certain investigations referred to under the heading "REGULATORY ISSUES AND CONTINGENCIES – Regulatory Issues – *Governmental and Regulatory Issues*" in this MD&A, which could result in one or more of the Mongolian, Canadian, United States or other governmental or regulatory agencies taking civil or criminal action against the Company, its affiliates or its current or former employees. The likelihood or consequences of such investigative actions are unclear at this time but could include financial or other penalties, which could be material, and which could have a material adverse effect on the Company and the value of the Common Shares.

For a description of the Tax Verdict refer to "REGULATORY ISSUES AND CONTINGENCIES – Regulatory Issues – Governmental and Regulatory Issues" in this MD&A.

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

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.

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 or regulation. 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 challenged resulting in their invalidation.

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.

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.

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.

The 2006 Minerals Law (as defined under the heading "DEFINITIONS AND OTHER INFORMATION – Defined Terms and Abbreviations" in the Annual Information Form), 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 has been subsequently amended and the potential for political interference has increased and the rights and security of title holders of mineral tenures in Mongolia has been weakened. 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 (as defined under the heading "DEFINITIONS AND OTHER INFORMATION – Defined Terms and Abbreviations" in the Annual Information Form). Refer to Risk Factor entitled "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, the Parliament of Mongolia enacted the Mining Prohibition in Specified Areas Law (the "Specified Areas Law") that prohibits minerals exploration and mining in areas such as headwaters of rivers and lakes, forest areas as defined in the Law of Forests of Mongolia of May 17, 2012, as amended, and areas adjacent to rivers and lakes as defined in the Law of Mongolia on Water enacted on May 17, 2012, as amended.

Pursuant to the Specified Areas Law, the Government of Mongolia has defined the boundaries of certain areas in which exploration and mining is purportedly prohibited. A list of licences has been prepared that overlap with the prohibited areas described in the law based on information submitted by water authority agencies, forest authority agencies and local authorities for submission to the Government of Mongolia.

Portions of the mining licence in respect of the Ovoot Tolgoi Mine and the exploration licences pertaining to the Zag Suuj Deposit and the South Biluut and Jargalant Fields within the Soumber Deposit are included on the list of specified areas described in the Specified Areas Law.

In regard to the Ovoot Tolgoi Mining Licence, the potential area which may be affected is a relatively small area which represents approximately 3% of the entire area of the mining licence and does not contain any reserves or resources or immovable assets. Accordingly, the loss of the potentially affected area would not materially and adversely affect the existing operations.

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

The Mining Prohibition in Specified Areas Law has not been adequately enforced to date mainly due to compensation issues due to the licence holders.

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

In order to address the issues facing its implementation, in February, 2015 the Parliament of Mongolia adopted an amendment to the Law on Implementation of the Mining Prohibition in Specified Areas Law (the "Amended Law on Implementation"). The Amended Law on Implementation provides an opportunity for license holders covered within the scope of application of the Mining Prohibition in Specified Areas Law to continue their mining operations subject to advance placement of funds to cover 100% of the future environmental rehabilitation costs. A model contract and a specific Government regulation on this requirement will be adopted by the Government. The license holders must also apply within 3 months after the amendment to the Law on Implementation comes into effect for permission to MRAM to resume activities. The Company submitted its application with respect to its mining licenses before the deadline set on June 16, 2015 and hasn't yet received any communication from MRAM on the status of its application.

Pursuant to the Mongolian Law "To prohibit mineral exploration and mining operations at headwaters of rivers, water protection zones and forested areas", the government administrative agency has notified the Company that special license area 12726A is partly overlapping with a water reservoir. The Company has inspected the area together with the Cadastral Division of the Mineral Resource Authority as well as through the cadastral registration system of the Ministry of Environment, it is determined that 29 hectares of Sukhait Bulag is partly overlapping with a water reservoir, of which has been partly handed over. (Resolution No.6/7522 issued on September 29, 2015 by the Head of Cadastral Division of the Mineral Resource Authority)

In accordance with Article 22.3 of Law of Mongolia on Water, 5,602.96 hectares of land, including Sukhaityn Bulag, Uvur Zadgai, and Zuun Shand pertaining to exploration license 9443X, which was converted to mining license MV-0125436 in January 2016, is overlapping with protected area boundary. It has been officially handed over to the local administration. (Resolution No.688 issued on September 24, 2015 by the Head of Cadastral Division of the Mineral Resource Authority) In connection with the nullification of Annex 2 of the government order No.194 "On determining boundary" issued on June 5, 2012, area around the water reservoir located at MV-016869 license area and Soumber exploration license 9449X, which was converted to mining license MV-020451 in January 2016, has been annulled from the Specified Area Law.

Therefore, mining license 12726A and MV-016869 and exploration licenses 9443X, 9449X were removed from the list of licenses that overlaps with the prohibited areas described in the law.

There has been limited development of the law during 2016 while two exploration licenses of the Company (13779X and 5267X) were converted to mining licenses (MV-020676 and MV-020675) in November 2016. The Company will continue to monitor the developments and ensure that it follows the necessary steps in the Amended Law on Implementation to secure its operations and licenses and is fully compliant with Mongolian law.

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, labour 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. Any restrictions imposed or charges levied or raised (including royalty fees) under Mongolian law for the export of coal could harm the Company's competitiveness.

14. Risk Factors continued

Risks Relating to the Company's Projects in Mongolia continued

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, which could materially and adversely affect the Company's business and results of operations.

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.

Under the 2006 Minerals Law, the State Great Khural of Mongolia (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 licence 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 licence holder. Details of any minerals reserves must be filed by the relevant licence 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 Parliament of Mongolia 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 licence 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 licence area is within, or overlaps, a Mineral Deposit of Strategic Importance.

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. continued

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 licence holder and the actual form of the Government of Mongolia's interest are subject to negotiation between the Government of Mongolia and the licence holder. In 2015, the Parliament of Mongolia adopted an amendment to the 2006 Minerals Law providing for the possibility for the Government to collect a special royalty on Mineral Deposits of Strategic Importance in lieu of holding an equity stake in such deposit. It stipulates that the parties can agree to transfer to the licence holder the state's share in the Mineral Deposit of Strategic Importance upon the approval of an authorized Government body, with the licence holder agreeing to pay a special royalty at a percentage (not to exceed 5%) to be approved by the Government.

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 licence 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 licences or exploration licences 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.

The Application of the Foreign Investment Law of Mongolia approved by the Parliament of Mongolia is uncertain.

Prior to October 3, 2013, the Company was subject to the Foreign Investment Law of Mongolia ("FIL") described in the Company's Management's Discussion and Analysis of Financial Condition and Results of Operation for the period ended December 31, 2012. The Company considers that this Risk Factor has been substantially mitigated following the repeal of the FIL and introduction of the Investment Law on October 3, 2013, which appears to provide greater certainty for foreign investment in Mongolia. However, that certainty remains subject to the inherent uncertainties of the legal system in Mongolia as described in the Risk Factor entitled the "Legislation in Mongolia may be subject to conflicting interpretations, which may have adverse consequences on the Company's business".

14. Risk Factors continued

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 largely 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 long term 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 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 both (i) technical risk in that they may not perform as designed, or (ii) operational redesign or modification as a result of on-going evaluation of the projects. 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.

DMCL is currently in the process of finalizing an updated technical report for the Ovoot Tolgoi Deposit, which will contain a full life of mine plan and address general items such as (i) processing and recovery operations, (ii) infrastructure, permitting and compliance, and (iii) capital and operating costs. DMCL's evaluation of these considerations is ongoing and there is no certainty that DMCL's conclusions will be congruent with the Company's vision of how it intends to conduct operations at Ovoot Tolgoi.

With respect to Soumber and Zag Suuj, 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 project scientific or technical information, 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 QPs 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.

Notwithstanding that DMCL has recently completed a comprehensive review in order to restate the mineral resource and reserve estimates for the Ovoot Tolgoi Mine, the Company also notes that, in general, mineral resource and reserve estimates are always subject to change based on new information. Specifically, 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. 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's results of operations are subject, to a significant extent, to economic, political and legal developments in China.

The Company expects that a majority if not all of the coal sales from the Ovoot Tolgoi Mine will be made to customers based in China. Accordingly, the economic, political and social conditions, as well as government policies, of China may affect its business. The Chinese 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 Chinese economy has been transitioning from a planned economy to a more market-oriented economy. For the past two decades, the Chinese government has implemented economic reform measures emphasizing the utilization of market forces in the development of the Chinese economy. Changes in the Chinese'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 Chinese 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 China could materially and adversely affect the Company's business and results of operations. Additionally, the Chinese 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.

14. Risk Factors continued

Risks relating to the Company's business and industry continued

The interests of the Company's principal stakeholders, CIC, Novel Sunrise and Voyage Wisdom, may differ from those of the other stakeholders.

On April 15, 2016, Novel Sunrise entered into the Option Agreement with the VWL Shareholders, all of whom are members of management, pursuant to which Novel Sunrise granted Voyage Wisdom a Call Option to purchase from Novel Sunrise, and Voyage Wisdom granted Novel Sunrise a Put Option to sell to Voyage Wisdom, 25.8 million common shares of the Company owned by Novel Sunrise, for a total purchase price of $24 million, payable in cash.

On January 11, 2017, Novel Sunrise reported that the Call Option was exercised, effective as at December 31, 2016, and as a result 25.8 million common shares of the Company were transferred to Voyage Wisdom from Novel Sunrise for $24 million.

As at March 31, 2017, CIC holds a total of 64.8 million Common Shares representing approximately 23.8% of the issued and outstanding Common Shares.

As at March 31, 2017, Novel Sunrise holds a total of approximately 46.4 million Common Shares representing approximately 17.0% of the issued and outstanding Common Shares.

As at March 31, 2017, Voyage Wisdom holds a total of approximately 25.8 million Common Shares representing approximately 9.5% of the issued and outstanding Common Shares.

As of March 31, 2017, CIC (also the Company's largest creditor by virtue of the CIC Convertible Debenture), Novel Sunrise and Voyage Wisdom hold approximately 23.8%, 17.0% and 9.5% of the Common Shares, respectively. The interests of each of these stakeholders may conflict with the interests of other Shareholders and there is no assurance that any of these stakeholders will vote its Common Shares in a way that benefits minority Shareholders. While no Shareholder has the ability to elect a majority of the Board unilaterally, both Novel Sunrise and CIC have been granted contractual director appointment rights. In addition, 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 of Common Shares among these parties.

Tax legislation in Mongolia is subject to varying interpretations and changes which may have a significant impact on the Company's financial position.

Mongolian tax, currency and customs legislation is subject to varying interpretations and changes, which can occur frequently. The interpretation by the Company's management of such legislation as applied to the transactions and activity of the Company may be challenged by the relevant authorities.

The Mongolian tax authorities may be taking a more assertive position in their interpretation of the legislation and assessments, and it is possible that transactions and activities that have not been challenged in the past may be challenged by tax authorities. As a result, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for five calendar years preceding the year of review. Under certain circumstances reviews may cover longer periods.

The Mongolian tax legislation does not provide definitive guidance in certain areas, specifically in areas such as VAT, withholding tax, corporate income tax, personal income tax, transfer pricing and other areas. From time to time, the Company adopts interpretations of such uncertain areas that reduce the overall tax rate of the Company. As noted above, such tax positions may come under heightened scrutiny as a result of recent developments in administrative and court practices. The impact of any challenge by the tax authorities cannot be reliably estimated; however, it may be significant to the financial position and/or the overall operations of the entity in question.

14. Risk Factors continued

Risks relating to the Company's business and industry continued

Tax legislation in Mongolia is subject to varying interpretations and changes which may have a significant impact on the Company's financial position. continued

Management believes that its interpretation of the relevant legislation is appropriate and the Company's positions related to tax and other legislation will be sustained. Management believes that tax and legal risks are remote at present. Management performs regular re-assessment of tax risk and its position may change in the future as a result of the change in conditions that cannot be anticipated with sufficient certainty at present.

As of 31 December 2016 and 2015, management has assessed that recognition of a provision for uncertain tax position is not necessary.

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 Canadian 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.

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

In Mongolia, the Company's mineral exploration licenses ("MELs") are subject to periodic renewal and may only be renewed a limited number of times for a limited period of time. 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. Although the Mongolian Government may have renewed the Company's licences and permits in the past, the Mongolian Government may retroactively revoke such renewals which could potentially result in the loss of the Company's MELs, pre-mining agreements ("PMAs") or mining licences. The Company's business objectives may also be impeded by the costs of holding and/or renewing the MELs in Mongolia. Licence fees for MELs increase substantially upon the passage of time from the original issuance of each individual MEL. The Company needs to continually assess the mineral potential of each MEL, particularly at the time of renewal, to determine if the costs of maintaining the MELs are justified by the exploration results to date, and may elect to let some of its MELs lapse. A moratorium on transfers of MELs has been imposed on two separate occasions and there is a risk that a similar moratorium could be imposed such that letting the MELs lapse may be the only practical option in some circumstances. Furthermore, the Company will require mining licences and permits to mine in order to conduct mining operations in Mongolia. There can be no assurance; however, that such licences and permits will be obtained on terms favourable to it or at all for the Company's future intended mining and/or exploration targets in Mongolia.

14. Risk Factors continued

Risks relating to the Company's business and industry continued

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

In April 2012, MRAM announced the suspension of exploration and mining activity on certain of the Company's licences including the licence pertaining to the Ovoot Tolgoi Mine. Although the Company did not receive official notification of a suspension of licences and had no reason to believe its licences were not in good standing, this announcement caused a significant disruption in the Company's business which ultimately lead to the curtailment of operations at the Ovoot Tolgoi Mine. Although the Company received a letter from MRAM on September 6, 2012 confirming that all MELs and mining licences were in good standing there is still a risk that its licences could be revoked.

In addition, certain provisions of the Law on Land of Mongolia enacted on June 7, 2002, as amended (the "Land Law of Mongolia") and the 2006 Minerals Law provide for the revocation of previously granted land use rights, MELs or mining licences on the grounds that the affected area of land has been designated as SNT. The Land Law of Mongolia 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 within one year the licence holder whose rights or licence status are affected. The failure to pay the compensation within the one year period would allow the licence holder to resume its operations. If any of the Company's land use rights, MELs or mining licences 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 and its business and results of operation might be adversely and materially affected.

On February 13, 2015, the License Areas were included into a special protected area (referred to as a Special Needs Territory or "SNT") newly set up by the Umnugobi Aimag's CRKh to establish a strict regime on the protection of natural environment and prohibit mining activities in the territory of the SNT.

On July 8, 2015, SGS and the Chairman of the CRKh, in his capacity as the respondent's representative, reached an agreement (the "Amicable Resolution Agreement") to exclude the License Areas from the territory of the SNT in full, subject to confirmation of the Amicable Resolution Agreement by the session of the CRKh. The parties formally submitted the Amicable Resolution Agreement to the appointed judge of the Administrative Court for her approval and requested a dismissal of the case in accordance with the Law of Mongolia on Administrative Court Procedure. On July 10, 2015, the judge issued her order approving the Amicable Resolution Agreement and dismissing the case, while reaffirming the obligation of CRKh to take necessary actions at its next session to exclude the License Areas from the SNT and register the new map of the SNT with the relevant authorities. Mining activities at the Soumber property cannot proceed until the License Areas are removed from the SNT.

On June 29, 2016, the Mongolian Parliament and CRKh election was held. As a result, the Company is aware that additional action may be taken in respect of the SNT; however, the Company has not yet received any indication on the timing of the next session of the CRKh.

The Company is confident of a positive outcome in its challenge of this new CRKh resolution; however, there is no assurance that the Company will receive adequate compensation and its business and results of operation might be adversely and materially affected.

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 Common 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, China and elsewhere in the world, milder or more severe than normal weather conditions, and production costs in major coal producing regions. The Chinese 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 China 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 are below the full cost of production of any of the Company's future mining operations and remain at such a level for any sustained period, the Company could experience increased losses and may decide to discontinue operations, which could require the Company to incur closure costs and result in further 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 that meets Mongolian authority regulations 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 to China. 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. 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 China.

In Mongolia, a bottleneck in the transportation of coal from the Ovoot Tolgoi Mine to customers in China 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, is affected by external factors such as disruptions caused by bad weather or is closed for repair, such as was the case during 2012, when the road connecting the Ovoot Tolgoi Mine to the Shivee Khuren Border Crossing was closed for over four weeks for repair.

On May 8, 2015, the commercial operation of the Paved Highway commenced and subsequently the unpaved highway which was previously used to transport coal through the Shivee Khuren Border Crossing was closed. The Paved Highway is expected to significantly increase the safety of coal transportation, reduce environmental impacts and improve efficiency and capacity of coal transportation. The paved highway is expected to have a carrying capacity in excess of 20 million tonnes of coal per year.

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 China. 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 China, 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.

14. Risk Factors continued

Risks relating to the Company's business and industry continued

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. The reputation and capability to operate continuously over the longer term are key factors in also attracting key personnel to its business. The Company is reinforcing its core values of ethical behavior in dealing with all its stakeholders from senior management down in order to ensure the Company attracts the right people to its business. 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.

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 China. Competition in the Chinese 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 China with other large Chinese and international coal mining companies. Due to location, some of the Company's Chinese competitors may have lower transportation costs than the Company does. The Chinese 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.

14. Risk Factors continued

Risks relating to the Company's business and industry continued

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

In order to address the continuing difficult coal market conditions in China, the Company has initiated a plan to change the existing product mix to higher value and higher margin outputs through a plan to commence washing certain grades of coal commencing in 2017 in order to produce more premium semi-soft coking coal and to initiate more processing of the lower grades of coal in order to reduce the ash content and improve the selling price and margins on its thermal coal product. The Company, together with DMCL, is in the process of completing a new mine plan, which will incorporate coal washing and processing systems and significantly higher volumes of production in order to complement the Company's projected new product mix and sales volume targets. Such plans are expected to involve the need for a significant level of stripping activities over the next two years and certain capital expenditures to achieve the designed production outputs. Such expenditures will require the Company to seek additional financing in the form of finance leases, debt or equity. The Company is currently in negotiations to finalize an agreement for a finance lease on the new wash plant facility but expects to need additional financing to complete the thermal coal processing facilities.

Depending on the ultimate success of the execution of the plan to wash and process the coal product (of which there can be no assurance), the Company will continue to depend 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. This market has also been price sensitive and significant price volatility impacts contract performance.

Additionally, the Company has been selling its coal products since 2008. The Company had 19 active customers with the largest customer representing approximately 67%, the second largest customer representing approximately 14%, the third largest customer representing approximately 6% and the remaining customers accounting for 13% of the Company's total sales for the year ended December 31, 2016. In order to mitigate this risk, the Company has been enhancing the sales strategy in order to expand its existing customer base.

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

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.

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. continued

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 mine will eventually close. The key tasks in relation to the closure of the mines involves (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 MNT, Chinese Renminbi, Hong Kong, and Canadian dollars. The Company's financial results are reported in United States dollars. The salaries for local laborers in Mongolia are paid in local currency. Sales of coal into China have been and may continue to be settled in United States dollars and Renminbi. The Company has a subsidiary in Hong Kong where some expenses are incurred in Hong Kong 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 United States dollar.

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, 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 favourable to it, and Shareholders may experience dilution in their holdings upon issuance or sale of additional Common Shares or other securities in the future.

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.

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 political situation in Mongolia and China; 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.

15. Outlook

Following the implementation of the "One Belt, One Road" program in China, Mongolia is considered to possess further cooperative opportunities in the energy, infrastructure and agriculture sectors. Although the general economic conditions (which include the exchange rate fluctuations of the MNT remain uncertain), the provision of an economic stabilization package of $5.5 billion by the International Monetary Fund and other partners in February 2017 definitely has brought a more positive outlook for the Mongolian economy, including the mining sector in particular.

The Company is well positioned to capture the resulting business opportunities between the two countries given i) strong strategic support from its largest shareholders (CIC and Cinda (Novel Sunrise's parent company)), which are both state-owned-enterprises in China; and ii) the Company has a strong operational record for the past ten years in Mongolia as one of the largest enterprises in the country.

With respect to coal markets in China, in 2016 the Chinese government announced its intention to restructure the coal industry. This restructuring remains in process and is intends to reduce coal production by approximately 500 million tonnes in the next three to five years to accelerate supply-side reform; reduce the number of working days of domestic coal miners from 330 working days/year to 276 working days/year; and prohibit of greenfield coal mine construction in China between 2016 and 2018.

Following the implementation of these measures, the coal supply in China was positively impacted and resulted in overall coal price increases during 2016 after years of difficulties.

The Company benefitted from the market environment which resulted with the increased average selling price although the impact was partially offset by the depreciation of Renminbi against USD and locked in prices under agreements negotiated during times of lower coal prices. The increase in selling price of the Company's coal has not tracked the increases in the coal index price in China, as such index has does not account for the challenges faced by the Company in respect of the geological location of the Ovoot Tolgoi Mine and the aforementioned historical sales agreements.

With the execution of the Company's enhanced sales strategy to expand the sales network and reach out to a wider group of end customers, the number of customers has increased from five in 2015 to 19 in 2016. The Company will continue to strive for revenue growth by expanding its customer base further inland.

15. Outlook continued

Looking forward to 2017, the Company remains cautiously optimistic regarding the Chinese coal market, which is expected to continue stabilizing.

While most coal miners were affected by the price decline over the past few years, with some being forced to cease operations and liquidate, those that endured and remained in the market with competitive assets are now benefitting from the rebound in the underlying market. The Company is well positioned with the Ovoot Tolgoi mine located only approximately 40km from China and several growth options including the Soumber Deposit and Zag Suuj Deposit.

However, the Chinese government policy regarding coal may change or may not be enforced based on market factors and could negatively affect the recent improvements in pricings. For example, the 276 working days/year limit was slackened in November 2016 to manage production and price levels. The Company will pay particular attention to the government policy in China and respond proactively if necessary.

Further, it is expected that the China government will implement more restrictive coal import policies, especially on lower grade coal, as a result of the government's initiatives to curb carbon emissions. The Company intends to improve its product mix by beginning to wash coal in 2017 to beneficiate a portion of its lower grade and higher-ash content coal into washed coal products, in order to meet increasing market demand for higher quality coal. The construction of the washing facilities at Ovoot Tolgoi has been commenced and the operation is expected to start in 2017.

The Company is keen to strengthen cost management and control to ensure operating efficiency. The Company has started engaging third party contract mining companies to enhance the flexibility of production level while maintaining product quality.

The Company is also evaluating various other business opportunities in addition to coal mining and trading in Mongolia to diversify the risk profile as well as to create greater value for investors.

The Company remains well positioned in the market, with a number of key competitive strengths, including:

- **Bridge between Mongolia and China** – The Company is well positioned to capture the resulting business opportunities between the two countries given i) strong strategic support from its largest shareholders (CIC and Cinda (Novel Sunrise's parent company)), which are both state-owned-enterprises in China; and ii) the Company has a strong operational record for ten years in Mongolia, being one of the largest enterprises in the country.

- **Strategic location** – The Ovoot Tolgoi Mine is located approximately 40km from China, which represents the Company's main coal market. The Company has an infrastructure advantage, being approximately 50km from a major Chinese coal distribution terminal with rail connections to key coal markets in China.

- **Expanded Resources and Declared Reserves** – As a result of work performed by DMCL, the Company increased its estimate of total resources at the Ovoot Tolgoi Deposit from those described in the 2016 Technical Report and has declared reserves for the Ovoot Tolgoi Deposit.

- **Several growth options** – The Company has several growth options including the Soumber Deposit and Zag Suuj Deposit, located approximately 20km east and approximately 150km east of the Ovoot Tolgoi Mine, respectively.

15. Outlook continued

Objectives

The Company's objectives for 2017 and the medium term are as follows.

- **Expand customer base with enhanced product mix** – The Company aims to strengthen the sales and logistics capabilities to expand the customer base further inland in China and to beneficiate the coal by washing.
- **Optimize cost structure** – The Company is focused on further cost reduction by improving productivity and operational efficiency with the engagement of third party contract mining companies while maintaining product quality and the sustainability of production.
- **Progress growth options** – Subject to available financial resources, the Company plans to further the development of the Soumber Deposit, while staying compliant with all government requirements in relation to its licenses and agreements.
- **Diversify the risk profile of the Company** – The Company is evaluating various business opportunities besides coal mining and coal trading in Mongolia, including but not limited to power generation and contract mining. The Company aims to bridge into the new era of Mongolia prosperity committed to contribute to the long term development of Mongolia.
- **Operate in a socially responsible manner** – The Company is focused on maintaining the highest standards in health, safety and environmental performance.

March 31, 2017

ENVIRONMENTAL, SOCIAL AND GOVERNANCE REPORT

SouthGobi believes that having sound environmental, social and governance ("ESG") performance is important to the continued sustainable development of its business and community. The Company is committed, not solely in creating value for its shareholders, but also in promoting environmental protection, social responsibility and effective corporate governance.

The Board of Directors 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 HESS Committee also reviews any incidents that occur and provides guidance on how to prevent any recurrences. During the course of 2016, the HESS Committee met three times, with two of the meetings held at our Ovoot Tolgoi mine site.

We uphold and value the principles of integrity and responsibility in our operations, and are constantly seeking ways to enhance our competitive edge by striving for excellence and embracing technological advances. We fulfill our social responsibility through our work in supporting the local community and by minimizing pollution to the environment. We also conduct an environmental monitoring program every year, which consists of checking soil quality, ground and surface water levels and quality, vegetation, fauna, air quality including dust and waste gas emissions, and reclamation and rehabilitation.

Being one of the largest employers in Mongolia, we provide a positive working environment and sustain strong safety guidelines for our employees to minimize the lost time injury. The Company has maintained a solid record of a low lost time injury frequency rate since establishment and without any lost time injury in 2016. We encourage and provide continuous training to our staff to boost morale and improve the efficiency.

Disclosures relating to the material ESG issues identified have been included in this ESG Report pursuant to the requirements of Appendix 27 of the Listing Rules. This ESG Report mainly covers the policies, initiatives and performance of the Company's business in relation to these issues, for the year ended 31 December 2016:

A. Environmental

A1: Emissions

The Company is required and willing to comply with the Environmental Protection Law of Mongolia for its mining activities. It includes specific regulations and guidelines on the protection of the land and soil, water and air within the areas it operates. In particular, the Law on Air of Mongolia has specifically identified the standards that the Company has to reach.

Within the framework of such relevant environmental laws and regulations, the Company aspires to demonstrate environmental leadership by keeping its environmental impact at a minimum by carrying out rehabilitation, biological offsetting, regular monitoring of pollutant emissions and taking relevant responsive measures and protecting the environment with the participation of locals in the area in which it operates.

In 2014, a weather station commenced operations at the mine site in order to gather site specific data every 10 minutes, including data for gas emissions.

In 2015, the emissions of sulphur dioxide, nitrogen dioxide, respirable and fine suspended particles (known as PM10 and PM2.5) through mining process were within Mongolian air quality standard MNS 4585:2007. The results were derived from the Company's environmental monitoring program where samples from selected areas were taken and passed to authorized laboratory for testing.

The results shown below demonstrates that our average results of the measured parameters were under the standard requirement for both 2015 and 2016.

	Measured parameters	Unit	Standard requirement	2015 average result	2016 average result
1	PM10 dust content	μg/m³	0.1	0.05	**0.06**
2	PM2.5 dust content	μg/m³	0.05	0.045	**0.41**
3	Sulphur Dioxide	μg/m³	0.45	0.03	**0.005**
4	Nitrogen Dioxide	μg/m³	0.085	0.03	**0.031**

Moreover, the Company has implemented environmental friendly waste management programs and is focused on recycling and reduction of wastes. In 2016, the Ovoot Tolgoi mine site generated 278 (2015: 253) tonnes of waste, including waste oil, used tires, car batteries and cartridges, and 75% (2015: 86%) of such were recycled wastes and donated to local residents and contract company for reuse.

A2: Use of resources

The Board, together with its HESS Committee are the highest decision-making authority in respect of energy conservation and environmental protection. The Company established a top-down management approach and assessment mechanism for energy conservation and environmental protection at three levels: head office, subsidiaries (branches) and plant (mine, section), in order to delegate responsibility, induced pressure onto each level, and connect incentives and constraints on all division.

– Energy consumption (electricity, gas, oil)

The details of energy consumption at mine site are as follows:

	Measured parameters	Unit	2015 Total consumption	2015 Per tonne produced	**2016 Total consumption**	**2016 Per tonne produced**
1	Electricity	kWh	1,232,875	0.63	**1,897,407**	**0.56**
2	Gas (propane, oxygen, acetylene, argon, nitrogen)	Gallon/3000 psi	185	94.8 (per million tonnes)	**162**	**47.9 (per million tonnes)**
3	Oil (Gear oil, Hydraulic oil, Engine oil)	tonnes	112	57.4 (per million tonnes)	**102**	**30.2 (per million tonnes)**

– Water consumption

In 2016, the Ovoot Tolgoi mine site consumed 21,296m³ (2015: 14,405m³) of water for domestic use. In addition, 140,555m³ (2015: 126,150m³) of water, which is from nearby pit and water pond, was used for dust compression. We continue to strive for minimizing the water consumption in dust compression by reducing the source pollution and emission during the mining process.

– Energy use efficiency initiatives

We have carried out the following measures to promote energy saving:

- conduct routine camp meeting for all employees about energy use efficiency;
- put up signage to remind employees to turn off the lights when unused;
- camp manager checks the lights every night;
- during the winter, heating is maintained and monitored at the correct temperature; and
- during the summer, air conditioners are only utilized according to specific schedule.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE REPORT

Sourcing water, water efficiency initiatives

We have conducted various measures to preserve water usage, especially at the mine site. In 2016, Ovoot Tolgoi mine site re-used grey water for planting. We have held various meetings with our employees and local residents to promote the importance and ways to preserve water and the efficient use of water. We have placed rubbish bins at different locations of water sources near the mine site to prevent littering, which directly affects the quality of water sources. Moreover, we constantly clean the water source points to ensure the water quality supplied to Ovoot Tolgoi and the nearby community.

A3: The Environment and Natural Resources

The Company adheres to the notion of producing green coal and building ecological mining sites. Great emphasis has been laid on soil and water conservation, land rehabilitation and greening, ecological projects and other efforts as motions to safeguard and improve local eco-environment and strive to advance the ecological progress.

The Company established annual environmental monitoring programme to monitor soil quality, underground water, reclamation and rehabilitation.

The Ovoot Tolgoi mining license area did not have large scale soil contamination by heavy metals associated with mining operations. Samplings were taken in 23 different locations and the results were all within the government standard requirement under MNS 5850:2008. The overall results for 2015 and 2016 is as follows:

For 2015:

Heavy metals	Unit	Chromium	Lead	Cadmium	Nickel	Zinc
Average	Mg/kg	25.4	17.4	0.024	18.3	106.9
Maximum	Mg/kg	53.1	25.1	0.065	23.4	139.9
Minimum	Mg/kg	16.2	5.8	0.003	10	36
MNS 5850:2008	Mg/kg	150	100	3	150	300

For 2016:

Heavy metals	Unit	Chromium	Lead	Cadmium	Nickel	Zinc
Average	**Mg/kg**	**32.5**	**0.16**	**0.13**	**17.52**	**38.62**
Maximum	**Mg/kg**	**66.13**	**2.42**	**1.25**	**30.6**	**91**
Minimum	**Mg/kg**	**4.55**	**0**	**0**	**4.13**	**3.01**
MNS 5850:2008	**Mg/kg**	**150**	**100**	**3**	**150**	**300**

We also tested 14 surface water points to monitor underground water quality. A total of 13 ions, acidity, and minimization are tested and the results were all up to standard.

Mining, rehabilitation and greening at Ovoot Tolgoi are conducted in a synchronized manner. Timely rehabilitation and greening has been carried out in accordance with the procedure of topsoil stripping, layering up, mining, back-filling, covering the topsoil and restoring vegetation, which enables a full-scale greening and restores the ecology to its pre-mining conditions. Since 2008, the Company carried out biological reclamation of a 50 hectare area and planted over 2,000 trees and shrubs to reduce greenhouse gas emissions.

Every year, the Company has to develop an environmental protection plan. The plan for 2016 has been approved by Ministry of Environment and Green Development of Mongolia. 52 activities were planned to minimize the impact on environment, including but not limited to air, soil, underground water, plants and animals.

B. Social

B1: Employment

The Company upholds an equal and non-discriminative employment policy to provide equal employment opportunities for all candidates, regardless of nationality, race, gender, religion belief and cultural background. Taking into account characteristics and development requirements of different positions, the Company actively provides job opportunities in suitable positions for women and ensures equal pay for equal work for both male and female employees. As of December 31, 2016, the Company had a workforce of 403 employees, including 81 female employees, representing 20% of the workforce. In 2016, the Company newly recruited 93 employees.

The Company believes that a diverse board will enhance the decision making of the Board by utilizing the difference in skills, experience and background, geographical and industry experience, ethnicity, gender, knowledge and length of services, and other distinguishing qualities of the members of the Board. In support of this belief, the Board adopted a Board Diversity Policy in March 2014. All Board appointments will continue to be based on merit, having due regard to the overall effectiveness of the Board and diversity will be one of the criteria considered in determining the optimum composition of the Board.

To retain the competitive employees, the Company has in place remuneration and welfare mechanism that are internally fair and externally competitive. The Company has implemented the appropriate policies and campaigns to encourage and incentivize employees to develop and realize their personal values. Based on annual performance appraisal, the Company paid salary, bonus and allowance totaling US$7.0 million to employees in 2016 (2015: US$7.3 million).

Employees are entitled to paid leave, maternity leave, paternity leave and other statutory leave in accordance with the law. The Company also provides paid sick leave and personal leave for the employees.

B2: Health and Safety

The health and safety of the Company's employees is a top priority and the Company constantly improves the occupational safety and health management system in order to reduce risks and create a safe working environment. The Company requires all employees to strictly comply with the health and safety policies.

The Company's safety management system is designed on the principles of continual improvement and adopts the "Plan, Do, Check and Review" methodology. The structure of the safety management system generally follows the layout of international standards such as MNS OHSAS 18001:2012 and AS/NZS 4801.

The system has 17 elements which are inter-related, and each of those have specific objective that enables the employees to identify and manage various health and safety threats. Each element includes measures which help employees to meet the requirements of respective objective. Some of the elements refer to fixed procedures that must be followed, and defined in safe work procedures. The health and safety performance standards also address specific risk areas and the precautions and guidelines set by the health and safety performance standards are mandatory for all employees.

As at December 31, 2016, the Company has a lost time injury frequency rate of 0.00 per 200,000 man hours based on a rolling 12-month average.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE REPORT

B3: Development and Training

The Company has conducted various training activities and has in place ongoing mechanisms for employees to enhance their skills and capabilities in order to provide a career development path for employees and to improve the efficiency of the Company.

In particular, there are various trainings in relation to health and safety at the mine site. We ensure all personnel involved in any operation or activities at mine site are knowledgeable of the risks and controls associated with and they are competent to perform those activities. All new employees, contractors and visitors of mine site must undertake relevant induction training, which includes reference to the significant health and safety risks identified at the managed site.

The health and safety training includes 2 major aspects: competency-based training and awareness training. Competency-based training provides training on risk analysis, operational controls, work place monitoring, management of change and incident management. Awareness training includes significant health and safety risks and activities, accountabilities of specific health and safety roles and responsibilities, and emergency response procedures.

During 2016, safety training was provided for 1,664 employees (2015: 792) which includes new employee training, refresh training, contractor new employee training, contractor refresh training and visitor induction. A total of 19,968 training hours was given in 2016 (2015: 9,504).

B4: Labour standards

The Company strictly prohibits the use of child and forced labour in all operations, and is committed to creating a work environment which respects human rights.

In strict compliance with laws and regulations regarding labour and human rights, the Company takes such measures as instituting and enhancing collective contract system, signing labour contracts with each employee, improving remuneration and welfare mechanism and strengthening occupational health management to protect employees' legitimate rights and interests. In case of any violation, the Company will carry out investigation and impose necessary action on the employing unit and demand rectification within a specified period. No breach of any standards, rules or regulations on child labour and forced labour has ever occurred.

B5: Supply Chain Management

The Company has been continuously improving its supply chain management, not only ensuring the stable supply of production materials and services, but also managing the suppliers to be in line with the Company's core values to uphold the environmental and social standards.

The Company regards the social value and social influence (especially the fulfilment of social responsibility) as important aspects in supplier assessment and enhanced admission management. According to specific admission requirements, the Company not only demands that a supplier presents certification of quality, environment and occupational health and safety regimes, but that the supplier's product and its production meets national environmental protection standards and regulations and has passed external expert assessment.

According to the Company's procurement guidelines, the agreements with suppliers include the Company's requirement and standards in terms of environment and safety concerns. The tools and equipment by the contractors are all inspected and evaluated to be in safe condition and confirm with the Company health and safety standards and site procedures.

B6: Product Responsibility

The Company's main coal products are the premium semi-soft coking coal, the standard semi-soft coking coal and the thermal coal. We strive to ensure steady supply of quality coal products to customers.

The Company actively promotes clean coal products featuring low sulphur, low ash and high calorific value. We sell coals with low ash and sulphur level with high calorific value. In general, our products ash level ranged from 12% to 28% with calorific value of 5,000 to 7,000 kcal/kg. The sulphur content is below 1.7% for most of our products. During 2016, we processed and screened 1.4 million tonnes of coal in order to lower the ash level.

Moving forward, we will commence dry and wash coal processing so that the production yield can be increased, as well as lowering the ash and sulphur content of our coal products. The processing plant for wash coal processing is under construction and is expected to deploy in 2017.

B7: Anti-corruption

Through the coordination of supervisory functions such as over-site, inspection, audit, petitioning and deploying supervisory committees, the Company continues to promote the construction of a monitoring system, strengthening the accountability and awareness of supervisory duties in all its employees, making greater effort to monitor corruption, devoting vigorous efforts to supervision and accountability, thereby accomplishing significant results in terms of building up the Company's culture and anti-corruption.

In 2012, the Company adopted the implementation of a revised Code of Business Conduct and Ethics (the "Ethics Policy") called "*The Way We Work*". The Ethics Policy is applicable to all employees, consultants, officers and Directors regardless of their position in the organization, at all times and everywhere the Company does business. It has clear guidelines in relation to anti-bribery due diligence, and standards relating to anti-corruption and conflicts of interest.

In addition to "*The Way We Work*", the Company has also adopted additional guidance notes and standards which form part of the Company's overall Ethics Policy. The guidance notes and standards adopted include: guidelines for investigations into allegations of serious wrongdoing, dawn raid guidance notes, anti-bribery due diligence guidelines, business integrity standards relating to anti-corruption and conflicts of interest (collectively "Code of Conduct Standards"), and the EthicsPoint program.

EthicsPoint is the Company's confidential whistleblowing program, which is administered by an independent third party, and is available for use when someone suspects or is aware of illegal, unsafe or inappropriate activity at work. EthicsPoint provides avenue for individuals to raise concerns confidentially and anonymously.

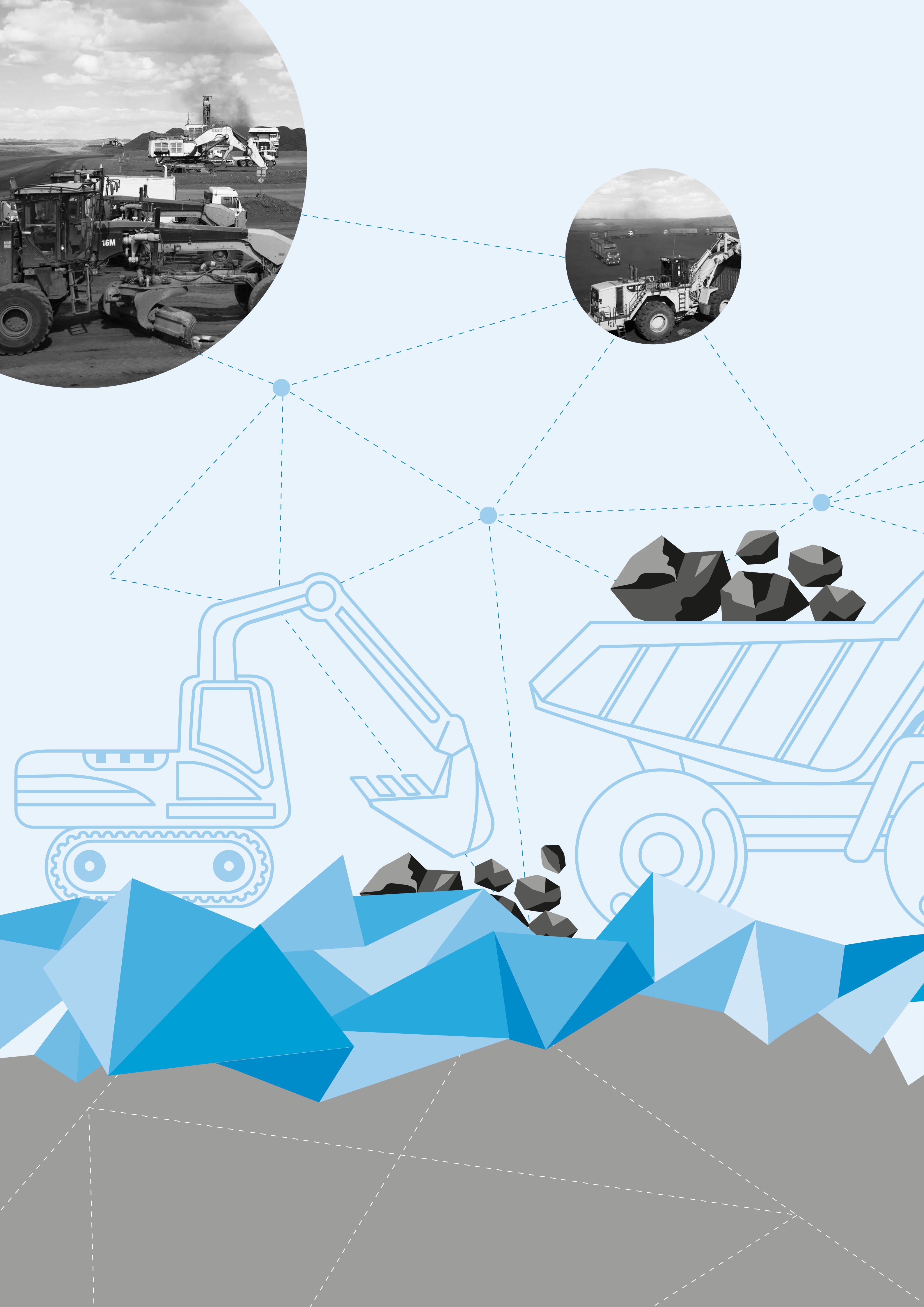
B8: Community investment

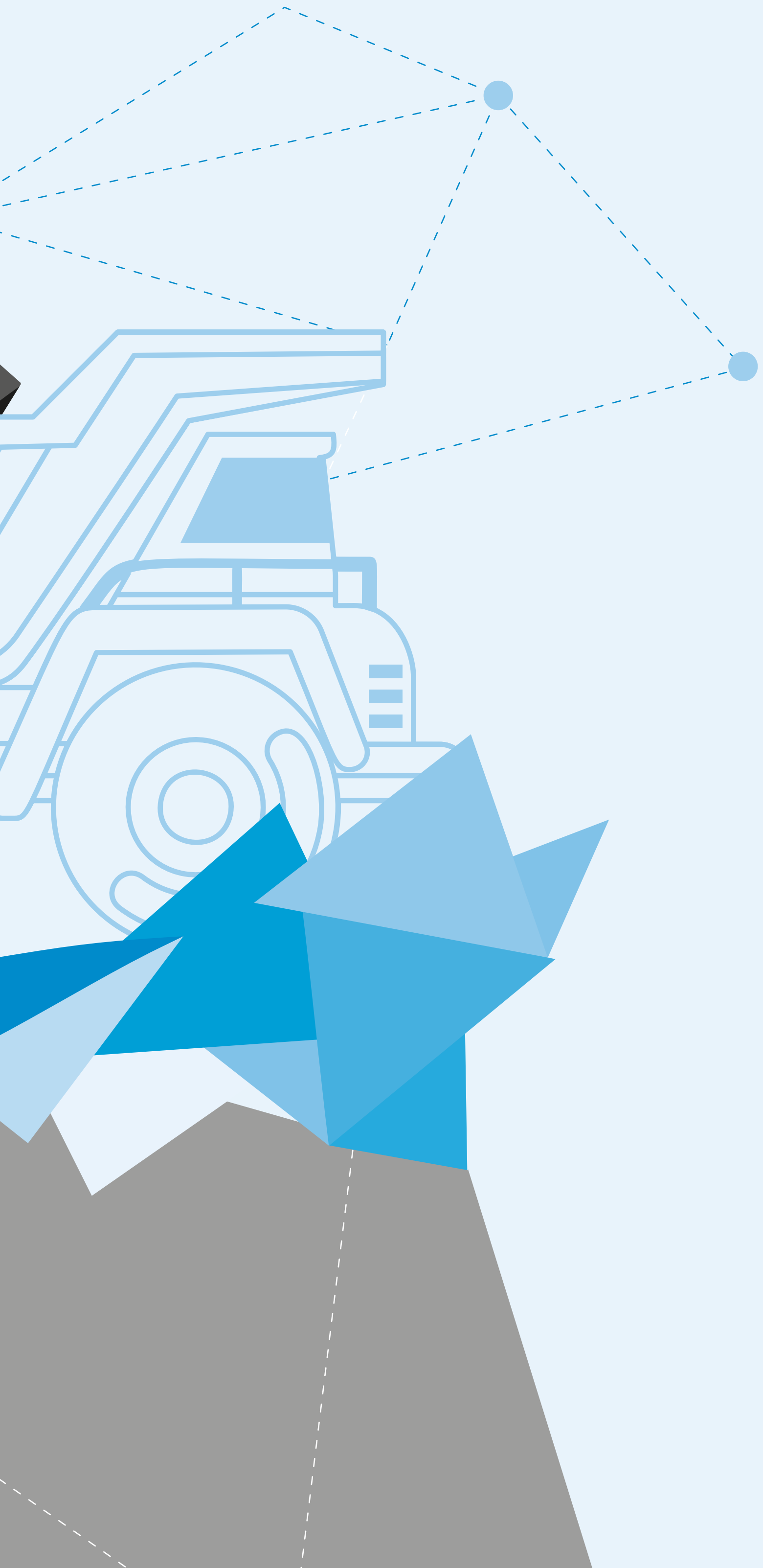
The Company proactively cares for the needs of the community by creating job opportunities and support the necessities of the community.

The Company encourages the employment of staff from the local community based on the principal of harmonious development. The Company's Ovoot Tolgoi Mine has created job opportunities in the Umnugobi Aimag (South Gobi province). The Company has 372 employees in Mongolia, of which 371 (99%) are Mongolian nationals and of those, 184 (49%) are residents of the local Gurvantes, Dalanzadgad, Sevrei and Noyon Soums.

The Company also supports and participates in the economic construction of the surrounding regions while developing. Thus, the Company enjoys good relationship with the local enterprises and government by supporting the local communities, for instance, supplying coal for free to nearby residents and build infrastructure for the local people.

During 2016, SouthGobi has made US$78,523 as charitable donations, of which it includes cash donations for different communities, coal donations, and airfare sponsors for local residents of Gurvantes as transportation between Ulaanbaatar and Ovoot Tolgoi.


16M



SEVERAL GROWTH OPTIONS

The Company has several growth options including the Soumber Deposit and Zag Suuj Deposit, located approximately 20km east and approximately 150km east of the Ovoot Tolgoi Mine, respectively.

CONSOLIDATED FINANCIAL STATEMENTS

Table of contents

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, 2016 and December 31, 2015 and the consolidated statements of comprehensive income, changes in equity and cash flows for the years then ended, and the related notes, which comprise 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, 2016 and December 31, 2015 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

Emphasis of matter

Without qualifying our opinion, we draw attention to Note 1 in the consolidated financial statements which describes matters and conditions that indicate the existence of a material uncertainty that casts significant doubt about the Company's ability to continue as a going concern.

signed "PricewaterhouseCoopers LLP"
Chartered Professional Accountants
Vancouver, Canada
March 31, 2017

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

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

	Notes	Year ended December 31, 2016	2015
Revenue	5	**$ 58,450**	$ 16,030
Cost of sales	7	**(87,045)**	(63,691)
Gross loss		**(28,595)**	(47,661)
Other operating expenses	8	**(50)**	(18,951)
Administration expenses	9	**(7,888)**	(7,509)
Evaluation and exploration expenses		**(422)**	(145)
Impairment of property, plant and equipment	16	**(1,152)**	(92,651)
Loss from operations		**(38,107)**	(166,917)
Finance costs	10	**(22,314)**	(21,371)
Finance income	10	**239**	1,302
Share of earnings of a joint venture	17	**806**	225
Loss before tax		**(59,376)**	(186,761)
Current income tax expense	11	**(1,470)**	(4)
Net loss attributable to equity holders of the Company		**(60,846)**	(186,765)
Other comprehensive loss to be reclassified to profit or loss in subsequent periods			
Exchange differences on translation of foreign operations	17	**(3,883)**	(1,275)
Net comprehensive loss attributable to equity holders of the Company		**$ (64,729)**	$ (188,040)
Basic and diluted loss per share	12	**$ (0.24)**	$ (0.79)

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, 2016	2015
Assets			
Current assets			
Cash and cash equivalents		**$ 966**	$ 377
Trade and other receivables	13	**19,434**	8,196
Inventories	14	**28,583**	32,262
Prepaid expenses and deposits	15	**8,194**	1,487
Total current assets		**57,177**	42,322
Non-current assets			
Property, plant and equipment	16	**180,809**	222,485
Investment in a joint venture	17	**21,335**	25,667
Total non-current assets		**202,144**	248,152
Total assets		**$ 259,321**	$ 290,474
Equity and liabilities			
Current liabilities			
Trade and other payables	18	**$ 43,628**	$ 30,917
Provision for court case penalty	19	**9,074**	16,468
Deferred revenue	20	**29,849**	11,683
Interest-bearing borrowings	21	**8,454**	8,905
Current portion of convertible debenture	22	**25,597**	16,671
Total current liabilities		**116,602**	84,644
Non-current liabilities			
Interest-bearing borrowings	21	**425**	–
Convertible debenture	22	**91,993**	91,988
Decommissioning liability	23	**4,288**	3,149
Total non-current liabilities		**96,706**	95,137
Total liabilities		**213,308**	179,781
Equity			
Common shares	24	**1,094,619**	1,094,618
Share option reserve	26	**52,340**	52,292
Exchange reserve		**(5,158)**	(1,275)
Accumulated deficit	24	**(1,095,788)**	(1,034,942)
Total equity		**46,013**	110,693
Total equity and liabilities		**$ 259,321**	$ 290,474
Net current liabilities		**$ (59,425)**	$ (42,322)
Total assets less current liabilities		**$ 142,719**	$ 205,830

Corporate information and going concern (Note 1), commitments for expenditure (Note 31) and contingencies (Note 32)

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

APPROVED BY THE BOARD:

"Mao Sun"

Director

"Yulan Guo"

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	Exchange fluctuation reserve	Accumulated deficit	Total
Balances, January 1, 2015	218,752	$ 1,080,417	$ 52,041	$ –	$ (848,177)	$ 284,281
Shares issued for:						
Interest settlement on convertible debenture	11,958	4,000	–	–	–	4,000
Private placement, net proceeds	16,619	6,580	–	–	–	6,580
Exercise of stock options, net of redemptions	12	9	(3)	–	–	6
Employee share purchase plan	11	6	–	–	–	6
Discretionary bonus shares	200	88	–	–	–	88
Conversion of mandatory convertible units	10,131	3,518	–	–	–	3,518
Share-based compensation charged to operations	–	–	254	–	–	254
Net loss for the year	–	–	–	–	(186,765)	(186,765)
Exchange differences on translation of foreign operations	–	–	–	(1,275)	–	(1,275)
Balances, December 31, 2015	257,683	$ 1,094,618	$ 52,292	$ (1,275)	$ (1,034,942)	$ 110,693
Balances, January 1, 2016	**257,683**	**$ 1,094,618**	**$ 52,292**	**$ (1,275)**	**$ (1,034,942)**	**$ 110,693**
Shares issued for:						
Employee share purchase plan	**15**	**1**	**–**	**–**	**–**	**1**
Share-based compensation charged to operations	**–**	**–**	**48**	**–**	**–**	**48**
Net loss for the year	**–**	**–**	**–**	**–**	**(60,846)**	**(60,846)**
Exchange differences on translation of foreign operations	**–**	**–**	**–**	**(3,883)**	**–**	**(3,883)**
Balances, December 31, 2016	**257,698**	**$ 1,094,619**	**$ 52,340**	**$ (5,158)**	**$ (1,095,788)**	**$ 46,013**

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, 2016	2015
Operating activities			
Loss before tax		$ **(59,376)**	$ (186,761)
Adjustments for:			
Depreciation and depletion		**40,666**	30,063
Share-based compensation	25	**48**	254
Finance costs	10	**22,314**	21,371
Finance income	10	**(239)**	(1,302)
Share of earnings of a joint venture	17	**(806)**	(225)
Interest paid		**(12,680)**	(2,390)
Commitment fee and front end fee		**–**	(50)
Income tax paid		**(248)**	(15)
Unrealized foreign exchange gain		**(2,900)**	(566)
Gain on disposal of property, plant and equipment		**–**	(116)
Provision for court case penalty	19	**–**	18,049
Provision for doubtful trade and other receivables	13	**2,641**	161
Impairment of inventories, net	14	**7,354**	15,263
Impairment of property, plant and equipment	16	**1,152**	92,651
Operating cash flows before changes in non-cash working capital items		**(2,074)**	(13,613)
Net change in non-cash working capital items	30	**4,835**	3,599
Cash generated from/(used in) operating activities		**2,761**	(10,014)
Investing activities			
Expenditures on property, plant and equipment		**(2,806)**	(8,432)
Interest received		**21**	3
Investment in a joint venture	17	**–**	(143)
Dividend received from a joint venture	17	**1,255**	–
Cash used in investing activities		**(1,530)**	(8,572)
Financing activities			
Proceeds from issuance of common shares, net of issue costs		**1**	10,198
New loans		**7,054**	5,004
Loan arrangement fee paid		**(252)**	–
Repayment of interest-bearing loans		**(7,382)**	–
Cash generated from/(used in) financing activities		**(579)**	15,202
Effect of foreign exchange rate changes on cash		**(63)**	(28)
Increase/(decrease) in cash		**589**	(3,412)
Cash, beginning of year		**377**	3,789
Cash, end of year		$ **966**	$ 377

Supplemental cash flow information (Note 30)

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

1. Corporate information and going concern

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 (Symbol: SGQ) and Hong Kong Stock Exchange (Symbol: 1878). The company, together with its subsidiaries (collectively referred to as the "Company"), is an integrated coal mining, development and exploration company. At December 31, 2016, Land Breeze II S.a.r.l., a wholly-owned subsidiary of China Investment Corporation ("CIC") owned approximately 19% of the outstanding Common Shares of the Company. Novel Sunrise Investments Limited ("Novel Sunrise"), a wholly-owned subsidiary of China Cinda (HK) Investments Management Company Limited ("Cinda") and Voyage Wisdom Limited each owned approximately 18% and 10% of the outstanding Common Shares of the Company, respectively.

The Company owns the following significant coal projects in Mongolia: the Ovoot Tolgoi open pit producing coal mine ("Ovoot Tolgoi Mine") and the following significant 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 of each other and in close proximity to the Mongolia-China border. The Company owns a 100% interest in these coal projects.

In June 2016, as part of the Company's strategy to expand the sales channels of coal in China, the Company incorporated a 100%-owned subsidiary in China, Inner Mongolia SouthGobi Energy Limited.

The head office, principal address and registered and records office of the Company is located at 1100 – 355 Burrard Street, Vancouver, British Columbia, Canada, V6C 2G8.

Going concern assumption

The Company's consolidated financial statements have been prepared on a going concern basis which assumes that the Company will continue operating until at least December 31, 2017 and will be able to realize its assets and discharge its liabilities in the normal course of operations as they come due. However, in order to continue as a going concern, the Company must generate sufficient operating cash flows, secure additional capital or otherwise pursue a strategic restructuring, refinancing or other transactions to provide it with additional liquidity.

Several adverse conditions and material uncertainties cast significant doubt upon the going concern assumption. The Company had a working capital deficiency (excess current liabilities over current assets) of $59,425 as at December 31, 2016 compared to $42,322 of working capital deficiency as at December 31, 2015. Included in the working capital deficiency at December 31, 2016 are significant obligations, which come due in the short-term, including the agreement to pay $19,696 to CIC from January to May 2017, pursuant to the interest deferral agreement (Note 22.5). Although the Company has been in discussions with CIC for a further deferral, there can be no assurance that a favorable outcome can be reached.

Further, the trade and other payables of the Company continue to accumulate due to liquidity constraints. The aging profile of the trade and other payables has risen as compared to that as at December 31, 2015, as follows:

	As at December 31, 2016	2015
Less than 1 month	**$ 14,640**	$ 9,465
1 to 3 months	**2,493**	3,282
3 to 6 months	**2,648**	6,075
Over 6 months	**23,847**	12,095
Total trade and other payables	**$ 43,628**	$ 30,917

The Company may not be able to settle all trade and other payables on a timely basis while continuing postponement in settling the trade payables may impact the mining operations of the Company and result in potential lawsuits and/or bankruptcy proceedings being filed against the Company. No such lawsuits or proceedings are pending as at March 31, 2017.

1. Corporate information and going concern continued

Going concern assumption continued

The Company also has other current liabilities, which require settlement in the short-term, including: the remaining cash payments of $3,013 due in connection with the Tax Penalty owing to the Government of Mongolia (Note 19); the Magnai Trade LLC ("MTLLC") settlement in the amount of $7,928, which is included in trade and other payables, due between March and June 2017 (Note 18.2); the $3,425 balance of the short-term bridge loan due in April 2017 (repaid in January and March 2017); the $2,881 balance of the Turquoise Hill Resources Limited ("Turquoise Hill") shareholder loan ("TRQ Loan") payable in monthly payments with the balance due in December 2017; and the bank loan of $2,026 due in May 2017.

The Company is also party to a commercial arbitration in Hong Kong (Note 32.7) with First Concept Logistics Limited ("First Concept"), involving an $11,500 amount received as a coal supply contract prepayment, whereby First Concept is seeking to recover its deposit rather than completing the contracted coal purchases. An arbitration decision, which would compel the Company to repay First Concept or alternatively, which would compel First Concept to take the coal will impact the liquidity of the Company.

In order to address the continuing difficult coal market conditions in China, the Company has initiated a plan to change the existing product mix to higher value and higher margin outputs by washing certain grades of coal commencing in 2017 in order to produce more premium semi-soft coking coal and to initiate more processing of the lower grades of coal in order to reduce the ash content and improve the selling price and margins on its thermal coal product. The Company has also completed a new mine plan, which incorporates the coal washing and processing systems and contemplates significantly higher volumes of production in order to complement the Company's new product mix and sales volume targets. Such plans will involve the need for a significant level of stripping activities over the next two years and require certain capital expenditures to achieve the designed production outputs. Such expenditures will require the Company to seek additional financing in the form of finance leases, debt or equity. The Company has entered into an agreement for a finance lease on the new wash plant facility (Note 31) but will need financing to complete the thermal coal processing facilities.

There is no guarantee that the Company will be able to successfully execute the measures mentioned above and secure other sources of financing. If it fails to do so, or is unable to secure additional capital or otherwise restructure or refinance its business in order to address its cash requirements through December 31, 2017, then the Company is unlikely to have sufficient capital resources or cash flows from mining operations in order to satisfy its current ongoing obligations and future contractual commitments. This could result in adjustments to the amounts and classifications of assets and liabilities in the Company's consolidated financial statements and such adjustments could be material.

Unless the Company acquires additional sources of financing and/or funding in the short term, the ability of the Company to continue as a going concern is threatened. If the Company is unable to continue as a going concern it may be forced to seek relief under applicable bankruptcy and insolvency legislation.

Continuing delay in securing additional financing could ultimately result in an event of default of the CIC Convertible Debenture, the TRQ Loan and the bank loan, which if not cured within applicable cure periods in accordance with the terms of respective instruments, may result in the principal amounts owing and all accrued and unpaid interest becoming immediately due and payable upon notice to the Company by CIC, Turquoise Hill and the lender of the bank loan, respectively.

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

1. Corporate information and going concern continued

Going concern assumption continued

Factors that impact the Company's liquidity are being closely monitored 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 and exploration and discretionary expenditures.

As at December 31, 2016, the Company's gearing ratio was 0.37 (2015: 0.33), which was calculated based on the Company's long term liabilities to total assets. As at December 31, 2016 and December 31, 2015, the Company is not subject to any externally imposed capital requirements.

2. Basis of preparation

2.1 Statement of compliance

The consolidated financial statements, including comparatives, have been prepared in accordance with and using accounting policies in compliance with the International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

The consolidated financial statements of the Company for the year ended December 31, 2016 were approved and authorized for issue by the Board of Directors of the Company on March 31, 2017.

2.2 Basis of presentation

The consolidated financial statements have been prepared on a historical cost basis except for certain financial assets and financial liabilities which are measured at fair value. The Company's financial instruments are further disclosed in Note 28.

2.3 Standards issued but not yet effective

The standards that are issued up to the date of issuance of the Company's financial statements, but were not effective during the year ended December 31, 2016, are disclosed below. The Company intends to adopt these standards, if applicable, when they become effective.

IFRS 9	Financial Instruments(i)
IFRS 15	Revenue from Contracts with Customers(i)
IFRS 16	Leases(ii)

(i) Effective for annual periods beginning on or after January 1, 2018

(ii) Effective for annual periods beginning on or after January 1, 2019

2. Basis of preparation continued

2.3 Standards issued but not yet effective continued

IFRS 9, Financial Instruments ("IFRS 9") – classification and measurement, addresses the classification, measurement and derecognition of financial assets and financial liabilities, introduces new rules for hedge accounting and a new impairment model for financial assets. While the Company has yet to undertake a detailed assessment of the classification and measurement of financial assets and liabilities, it is not expected that the new guidance to have a significant impact on the classification and measurement of its financial assets and liabilities.

The new impairment model requires the recognition of impairment provisions based on expected credit losses ("ECL") rather than only incurred credit losses as is the case under IAS 39. It applies to financial assets classified at amortised cost. While the Company has not yet undertaken a detailed assessment of how its impairment provisions would be affected by the new model, it may result in an earlier recognition of credit losses.

The new standard also introduces expanded disclosure requirements and changes in presentation. These are expected to change the nature and extent of the Company's disclosures about its financial instruments particularly in the year of the adoption of the new standard.

The standard is effective for accounting periods beginning on or after January 1, 2018. Early adoption is permitted.

IFRS 15, Revenue from Contracts with Customers ("IFRS 15"), deals with revenue recognition and establishes principles for reporting useful information to users of financial statements about the nature, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Revenue is recognized when a customer obtains control of a good or service and thus has the ability to direct the use and obtain the benefits from the good or service. The standard replaces IAS 18, Revenue, and IAS 11, Construction Contracts, and related interpretations. The standard is effective for annual periods beginning on or after January 1, 2018 and earlier application is permitted. The Company has yet to assess IFRS 15's impact on its financial statements.

IFRS 16, Leases ("IFRS 16"), on January 13, 2016 the IASB issued IFRS 16, according to which, all leases will be recognized on the balance sheet, as the distinction between operating and finance leases is removed. Under the new standard, an asset (the right to use the leased item) and a financial liability to pay rentals are recognized. The only exceptions are short-term and low-value leases.

The standard will affect primarily the accounting for the Company's operating leases. As at the reporting date, the Company has non-cancellable operating lease commitments of $7,459. However, the Company has not yet determined to what extent these commitments will result in the recognition of an asset and a liability for future payments and how this will affect the Company's profit and classification of cash flows. Some of the commitments may be covered by the exception for short-term and low-value leases and some commitments may relate to arrangements that will not qualify as leases under IFRS 16.

The standard is effective for annual periods beginning on or after January 1, 2019.

There are no other IFRS or IFRIC interpretations with future effective dates that are expected to have a material impact on the Company.

3. Summary of significant accounting policies

3.1 Basis of consolidation

The consolidated financial statements include the financial statements of SouthGobi Resources Ltd. and its controlled subsidiaries (Note 29).

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.

The Company controls an entity when the Company is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity.

3.2 Foreign currencies

The consolidated financial statements are presented in the U.S. Dollar, which is the functional currency of SouthGobi Resources Ltd. Each entity in the Company determines its own functional currency and items included in the financial statements of each entity are measured using that functional currency. Transactions in foreign currencies are initially recorded at the U.S. Dollar rate of exchange at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the U.S. Dollar 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 rate prevailing at the date of the transaction. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rate at the date when the fair value is determined.

The functional currency of the joint venture, RDCC LLC, is the Mongolian Tugrik ("MNT"). At the end of the reporting period, the assets and liabilities of the entity are translated into the U.S. Dollar at the exchange rates prevailing at the end of the reporting period and the profit or loss is translated into the U.S. Dollar at the weighted average exchange rate for the year. The resulting exchange differences are recognized in other comprehensive income and accumulated in the exchange fluctuation reserve. On disposal of a foreign operation, the component of other comprehensive income relating to that particular foreign operation is recognized in profit or loss.

3.3 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 capitalized as part of the cost of those assets. All other borrowing costs are expensed and included in profit or loss.

3.4 Inventories

Coal stockpile inventories are measured at the lower of production cost and net realizable value. Production cost is determined by the weighted average cost 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 to complete production 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, less allowances for obsolescence. Replacement cost is used as the best available measure of 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.

3. Summary of significant accounting policies continued

3.5 Leases

Leases that transfer substantially all the rewards and risks of ownership of assets to the Company, other than legal title, are accounted for as finance leases. At the inception of a finance lease, the cost of the leased asset is capitalized at the present value of the minimum lease payments and recorded together with the obligation, excluding the interest element, to reflect the purchase and financing. Assets held under finance leases, including prepaid land lease payments under finance leases, are included in property, plant and equipment, and depreciated over the shorter of the lease terms and the estimated useful lives of the assets. The finance costs of such leases are charged to profit or loss so as to provide a constant periodic rate of charge over the lease terms.

Assets acquired through hire purchase contracts of a financing nature are accounted for as finance leases, but are depreciated over their estimated useful lives.

Leases where substantially all the rewards and risks of ownership of assets remain with the lessor are accounted for as operating leases. Where the Company is the lessee, rentals payable under operating leases net of any incentives received from the lessor are charged to profit or loss on the straight-line basis over the lease terms.

3.6 Property, plant and equipment

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

Initial recognition

The cost of an item of operating equipment and infrastructure consists of the purchase price or construction cost, including vendor prepayments, 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 property, plant and equipment 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 also includes mineral property development costs, certain production stripping costs and decommissioning liabilities related to the reclamation of the Company's mineral properties.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

3. Summary of significant accounting policies continued

3.6 Property, plant and equipment continued

Depreciation and depletion

Depreciation and depletion are recorded based on the cost of an item of property, plant and equipment, 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 20 years
Construction in progress	not depreciated
Mineral properties	unit-of-production basis based on proven and probable reserves

Upon disposal, reclassification to assets held for sale or when no future economic benefits are expected to arise from the continued use of an asset the original cost and related accumulated depreciation is removed from property, plant and equipment. 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, estimated useful lives and depreciation methods being used for property, plant and equipment and any changes arising from the assessment are applied by the Company prospectively.

3.7 Mineral properties

Evaluation and exploration expenses

Evaluation and exploration expenses are charged to profit or loss in the period incurred until such time as it has been determined that a mineral property has technically feasibility, commercially viability and management has determined that the mineral property will be developed.

Production phase

Upon a mine development being ready for its intended use it enters the production phase and depletion of the mineral property is recorded on a unit-of-production basis using the estimated resources, which are expected to be mined in the mine plan, as the depletion base. Management's determination of when an asset is ready for its intended use 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; and
- the commissioning of major operating equipment and infrastructure is completed.

3.8 Development and production stripping costs

Once a property is determined to have reached technical feasibility, commercially viability and management has determined that the mineral property will be developed, the Company's subsequent exploration and evaluation and development expenses are capitalized as mineral property costs within property, plant and equipment.

Production stripping activity assets are recognized when the following three criteria are met:

- it is probable that the future economic benefit (improved access to the ore body) associated with the stripping activity will flow to the entity;
- the entity can identify the component of the ore body for which access has been improved; and
- the costs relating to the stripping activity associated with that component can be measured reliably.

If not all of the criteria are met, the stripping activity costs are included in the costs of inventory produced during the period incurred.

3. Summary of significant accounting policies continued

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 discount rate and the amount or timing of the underlying cash flows required to settle the obligation. The discount rate used is a credit adjusted risk free rate.

3.10 Joint arrangements

The Company classifies joint arrangements as either joint operations or joint ventures, depending on the rights and obligations of the parties involved in the joint arrangement. Joint arrangements that are classified as joint operations require the venturers to recognize the individual assets, liabilities, revenues and expenses to which they have legal rights or are responsible. Joint arrangements that are classified as a joint venture are accounted for using the equity method of accounting. The Company accounts for its investment in RDCC LLC (Note 17) as a 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 the value of some or all of the goods or services received by the entity as consideration cannot be measured reliably, 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.

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. Summary of significant accounting policies continued

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. The Company's 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.

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.

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.

3. Summary of significant accounting policies continued

3.13 Taxation continued

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.

3.14 Financial assets

All financial assets are initially recorded at fair value and categorized 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 categorized as FVTPL are measured at fair value with unrealized gains and losses recognized through profit or loss.

Financial assets categorized 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 categorized as available-for-sale are measured at fair value with unrealized gains and losses recognized in other comprehensive income except when there is objective evidence that the financial asset is impaired. Impairment losses on available-for-sale financial assets are recognized in profit or loss.

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 categorized 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 categorized as FVTPL include financial liabilities designated upon initial recognition as FVTPL. Derivatives, including separated embedded derivatives, are also classified as FVTPL 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.

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.

3.18 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 fair value less costs to sell, recent market transactions are taken into account. The Company also considers the results of an appropriate valuation model which would generally be determined based on the present value of estimated future cash flows arising from the continued use and eventual disposal of the asset. 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 profit or loss.

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. Summary of significant accounting policies continued

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 are transferred to the buyer and the selling prices are known or can be reasonably estimated.

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 the 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

Information about judgments and estimates in applying accounting policies that have the most significant effect on the amounts recognized in the consolidated financial statements are as follows:

Liquidity and the going concern assumption

In the determination of the Company's ability to meet its ongoing obligations and future contractual commitments, management relies on the Company's 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. The key inputs used by the Company in this process include forecasted capital deployment, results from operations, results from the exploration and development of its properties and general industry conditions as well as the expected timing of payments of suppliers and the repayment of debt and other financial liabilities. Refer to Note 1 for details.

While the Company intends to secure additional sources of financing as soon as possible, a continued delay in securing additional financing could ultimately result in an event of default of the CIC Convertible Debenture, the TRQ Loan and the bank loan, which if not cured within applicable cure periods in accordance with the terms of such instruments, may result in the principal amounts owing and all accrued and unpaid interest becoming immediately due and payable upon notice to the Company by CIC, Turquoise Hill and the lender of the bank loan, respectively.

3. Summary of significant accounting policies continued

3.23 Significant accounting judgments and estimates continued

Valuation of embedded derivatives

The embedded derivatives in the Company's 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.

The key inputs used by the Company in its Monte Carlo simulation are further disclosed in Note 22.2 and Note 22.3. Changes in the inputs to the valuation model could impact the carrying value of the embedded derivatives in the convertible debenture and the amount of unrealized gains or losses recognized in profit or loss. The carrying value of the embedded derivatives in the Company's convertible debenture as at December 31, 2016 was a liability of $540 (2015: $757).

Review of carrying value of assets and impairment charges

In the determination of carrying values and impairment charges, management of the Company reviews the recoverable amount (the higher of the fair value less costs of disposal or the value in use) in the case of non-financial assets and objective evidence indicating impairment in the case of financial assets. These determinations and their individual assumptions require that management make a decision based on the best available information at each reporting period. Changes in these assumptions may alter the results of non-financial asset and financial asset impairment testing, impairment charges recognized in profit or loss and the resulting carrying amounts of assets.

Ovoot Tolgoi Mine cash generating unit

The Company determined that an indicator of impairment existed for its Ovoot Tolgoi Mine cash generating unit as at December 31, 2016. The impairment indicator was the uncertainty of future coal prices in China.

Therefore, the Company conducted an impairment test whereby the carrying value of the Company's Ovoot Tolgoi Mine cash generating unit was compared to its "fair value less costs of disposal" ("FVLCTD") using a discounted future cash flow valuation model. The Company's cash flow valuation model takes into consideration the latest available information to the Company, including but not limited to, sales price, sales volumes and washing assumptions, operating cost and life of mine coal production assumptions as at December 31, 2016. The Company's Ovoot Tolgoi Mine cash generating unit carrying value was $169,309 as at December 31, 2016.

Key estimates and assumptions incorporated in the valuation model included the following:

- Coal resources and reserves as estimated by an independent third party engineering firm;
- Sales price estimates from an independent market consulting firm;
- Forecasted sales volumes in line with production levels as per the updated mine plan;
- Updated life-of-mine coal production, strip ratio, capital costs and operating costs;
- Coal washing to increase the volume of premium semi-soft coking coal sold;
- Coal processing to increase the grade and qualities of the thermal coal produced and sold; and
- A post-tax discount rate of 13.5% based on an analysis of the market, country and asset specific factors.

3. Summary of significant accounting policies continued

3.23 Significant accounting judgments and estimates continued

Review of carrying value of assets and impairment charges continued

The impairment analysis did not result in the identification of an impairment loss or an impairment reversal and no charge or reversal was required as at December 31, 2016. The Company also conducted an impairment analysis in the prior year and an impairment loss of $76,700 was charged to other operating expenses for the year ended December 31, 2016. The Company believes that the estimates and assumptions incorporated in the impairment analysis are reasonable; however, the estimates and assumptions are subject to significant uncertainties and judgments.

Investment in RDCC LLC

At each reporting date, the Company reviews its investment in RDCC LLC to determine whether there are any indications of impairment. As at December 31, 2016, management of the Company determined that the current toll rate being lower than the rate per the concession agreement, constituted an impairment indicator. Therefore, the Company completed an impairment assessment for the investment in RDCC LLC whereby the carrying value of the investment was compared to its recoverable amount using assumptions consistent with those used at December 31, 2015. Management's impairment evaluation did not result in the identification or reversal of an impairment loss as at December 31, 2016.

Estimated Resources

The Company estimates its mineral resources based on information compiled by appropriately qualified persons relating to the geological data on the size, depth and shape of the ore body, and requires complex geological judgments to interpret the data. Changes in resource estimates may impact the carrying value of mining interests, mine restoration provisions, recognition of deferred tax assets, and depreciation and amortization charges.

Estimated Recoverable Reserves

Reserve 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 estimates and assumptions with respect to coal prices, operating costs, mine plan and life, coal quality and recovery, foreign currency exchange rates and inflation rates. Reserve estimates are made by qualified persons, but will be impacted by changes in the above estimates and assumptions.

Estimated recoverable reserves are used to determine the depletion of mineral properties, in accounting for deferred production stripping costs, in performing impairment testing and for forecasting the timing of the payment of decommissioning, restoration and similar costs. Therefore, changes in the estimates and assumptions used to determine recoverable reserves could impact the carrying value of assets, depletion expense and impairment charges recognized in profit or loss and the carrying value of the decommissioning, restoration and similar liabilities.

Useful lives and depreciation rates for property, plant and equipment

Depreciation expense is allocated based on estimated property, plant and equipment useful lives and depreciation rates except the mineral properties are depreciated on unit-of production basis based on proven and probable reserves. Therefore, changes in the useful life or depreciation rates from the initial estimate could impact the carrying value of property, plant and equipment and an adjustment would be recognized in profit or loss.

4. Segmented information

The Company's one reportable operating segment is its Coal Division. The Company's Chief Executive Officer (chief operating decision maker) reviews the 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

4. Segmented information continued

During the year ended December 31, 2016, the Coal Division had 19 active customers with the largest customer accounting for 67% of revenues, the second largest customer accounting for 14% of revenues, the third largest customer accounting for 6% of revenues and the other customers accounting for the remaining 13% of revenues.

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

	Coal Division	Unallocated[i]	Consolidated Total
Segment assets			
As at December 31, 2016	**$ 257,256**	**$ 2,065**	**$ 259,321**
As at December 31, 2015	288,974	1,500	290,474
Segment liabilities			
As at December 31, 2016	**$ 81,288**	**$ 132,020**	**$ 213,308**
As at December 31, 2015	51,404	128,377	179,781
Segment loss			
For the year ended December 31, 2016	**$ (31,943)**	**$ (28,903)**	**$ (60,846)**
For the year ended December 31, 2015	(162,534)	(24,231)	(186,765)
Segment revenues			
For the year ended December 31, 2016	**$ 58,450**	**$ –**	**$ 58,450**
For the year ended December 31, 2015	16,030	–	16,030
Impairment charge on assets[ii]			
For the year ended December 31, 2016	**$ 11,147**	**$ –**	**$ 11,147**
For the year ended December 31, 2015	108,075	–	108,075
Depreciation and amortization			
For the year ended December 31, 2016	**$ 46,132**	**$ 185**	**$ 46,317**
For the year ended December 31, 2015	49,188	18	49,206
Share of earnings of a joint venture			
For the year ended December 31, 2016	**$ 806**	**$ –**	**$ 806**
For the year ended December 31, 2015	225	–	225
Finance cost			
For the year ended December 31, 2016	**$ 816**	**$ 21,498**	**$ 22,314**
For the year ended December 31, 2015	566	20,805	21,371
Finance income			
For the year ended December 31, 2016	**$ 21**	**$ 218**	**$ 239**
For the year ended December 31, 2015	222	1,080	1,302
Current income tax charge			
For the year ended December 31, 2016	**$ 1,470**	**$ –**	**$ 1,470**
For the year ended December 31, 2015	4	–	4

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

(ii) The impairment charge on assets for the year ended December 31, 2016 relates to trade and other receivables (Note 13), inventories (Note 14) and property, plant and equipment (Note 16). The impairment charge on assets for the year ended December 31, 2015 relates to trade and other receivables (Note 13), inventories (Note 14), prepaid expenses and deposits (Note 15) and property, plant and equipment (Note 16).

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

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

4. Segmented information continued

	Mongolia	Hong Kong	Canada	China	Consolidated Total
Revenue [i]					
For the year ended December 31, 2016	$ **–**	$ **–**	$ **–**	$ **58,450**	$ **58,450**
For the year ended December 31, 2015	–	–	–	16,030	16,030
Non-current assets					
As at December 31, 2016	$ **201,053**	$ **599**	$ **100**	$ **392**	$ **202,144**
As at December 31, 2015	248,026	26	100	–	248,152

(i) The revenue information above is based on the locations of the customers.

5. Revenue

Revenue represents the net invoiced value of goods sold which arises from the trading of coal.

6. Expenses by Nature

The Company's loss before tax is arrived at after charging/(crediting):

	Year ended December 31, 2016	2015
Depreciation	$ **38,511**	$ 27,945
Auditors' remuneration	**422**	332
Employee benefit expense (including directors' remuneration)		
Wages and salaries	$ **6,729**	$ 6,650
Equity-settled share option expense (Note 25)	**48**	254
Pension scheme contributions	**675**	650
Total expenses	$ **7,452**	$ 7,554
Minimum lease payments under operating leases	$ **890**	$ 882
Foreign exchange gain	**(5,423)**	(896)
Impairment of property, plant and equipment (Note 16)	**1,152**	92,651
Impairment of materials and supplies inventories (Note 14)	**–**	675
Impairment of coal stockpile inventories (Note 14)	**7,354**	14,588
Provision for doubtful trade and other receivables (Note 12)	**2,641**	161
Loss on settlement of prepayments	**–**	712
Discounting on settlement of trade payables (Note 8)	**(1,009)**	–
Mining services, net (Note 8)	**1,006**	–
Settlement of civil claims (Note 18)	**2,652**	–
Provision for court case penalty (Note 19)	**–**	18,049
Mine operating cost and other	**40,909**	20,294
Total expenses	$ **96,557**	$ 182,947

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

7. Cost of sales

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

	Year ended December 31, 2016	2015
Operating expenses	**$ 41,452**	$ 18,266
Share-based compensation expense/(recovery) (Note 25)	**(8)**	42
Depreciation and depletion	**26,142**	5,361
Impairment of coal stockpile inventories (Note 14)	**7,354**	14,588
Cost of sales from mine operations	**74,940**	38,257
Cost of sales related to idled mine assets[i]	**12,105**	25,434
Cost of sales	**$ 87,045**	$ 63,691

(i) Cost of sales related to idled mine assets for the year ended December 31, 2016 includes $12,105 of depreciation expense (2015: includes $22,462 of depreciation expenses). The depreciation expense relates to the Company's idled plant and equipment.

Cost of inventories recognized as expense in cost of sales for the year ended December 31, 2016 totaled $62,931 (2015: $12,026).

8. Other operating expenses

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

	Year ended December 31, 2016	2015
Foreign exchange gain	**$ 5,423**	$ 896
Provision for doubtful trade and other receivables (Note 13)	**(2,641)**	(161)
Discount on settlement of trade payables	**1,009**	–
Mining services, net	**(1,006)**	–
Settlement of civil claims (Note 18)	**(2,652)**	–
Loss on settlement of prepayments	**–**	(712)
Impairment of materials and supplies inventories (Note 14)	**–**	(675)
Provision for court case penalty (Note 19)	**–**	(18,049)
Other	**(183)**	(250)
Other operating expenses	**$ (50)**	$ (18,951)

Mining services at the Tavan Tolgoi deposit were provided at a net cost of $1,006, consisting of direct mining costs and depreciation totaling $3,080, net of service revenue of $2,074 (Note 19). No similar amount was incurred in 2015.

9. Administration expenses

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

	Year ended December 31, 2016	2015
Corporate administration	**$ 2,724**	$ 2,112
Legal and professional fees	**2,022**	2,921
Salaries and benefits	**2,820**	2,155
Share-based compensation expense (Note 25)	**58**	199
Depreciation	**264**	122
Administration expenses	**$ 7,888**	$ 7,509

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

10. Finance costs and income

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

	Year ended December 31, 2016	2015
Interest expense on convertible debenture (Note 22)	$ 21,279	$ 20,549
Interest expense on borrowings (Note 21)	781	475
Commitment fee and front end fee (Note 21)	–	50
Loan arrangement fee (Note 21)	159	190
Accretion of decommissioning liability (Note 23)	95	107
Finance costs	**$ 22,314**	$ 21,371

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

	Year ended December 31, 2016	2015
Unrealized gain on embedded derivatives in convertible debenture (Note 22)	$ 217	$ 1,077
Gain on waiver of loan from Turquoise Hill	–	200
Interest income	22	25
Finance income	**$ 239**	$ 1,302

11. Taxes

11.1 Income tax recognized in profit or loss

The Canadian statutory tax rate was 26% (2015: 26%). A reconciliation between the Company's tax expense and the product of the Company's loss before tax multiplied by the Company's domestic tax rate is as follows:

	Year ended December 31, 2016	2015
Loss before tax	$ (59,376)	$ (186,761)
Statutory tax rate	26.00%	26.00%
Income tax recovery based on combined Canadian federal and provincial statutory rates	(15,438)	(48,558)
Deduct:		
Lower effective tax rate in foreign jurisdictions	610	13,604
Tax effect of tax losses and temporary differences not recognized	6,529	5,553
Non-deductible expenses	9,769	29,405
Income tax expenses	**$ 1,470**	$ 4

11.2 Deferred tax balances

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

	As at December 31, 2016	2015
Tax loss carryforwards	$ 15,339	$ 11,558
Property, plant and equipment and other assets	(15,339)	(11,558)
Total deferred tax balances	**$ –**	$ –

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)

11. Taxes continued

11.3 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, 2016	2015
Non-capital losses	$ **141,480**	$ 133,756
Capital losses	**30,049**	30,049
Foreign exchange and others	**376,531**	300,197
Total unrecognized amounts	$ **548,060**	$ 464,002

11.4 Expiry dates

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

	As at December 31, 2016 U.S. Dollar Equivalent	Expiry dates
Non-capital losses		
Canada	$ **139,659**	2032 – 2036
Mongolia[i]	**49,280**	2017 – 2020
China	**1,821**	2020 – 2021
	$ **190,760**	
Capital losses		
Canada	$ **30,049**	indefinite

[i] The tax loss in Mongolia is subject to final approval from the Mongolian tax authorities.

12. Loss per share

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

	Year ended December 31, 2016	2015
Net loss	$ **(60,846)**	$ (186,765)
Weighted average number of shares	**257,692**	237,560
Basic and diluted loss per share	$ **(0.24)**	$ (0.79)

Potentially dilutive items not included in the calculation of diluted loss per share for the year ended December 31, 2016 include the convertible debenture (Note 22) and stock options (Note 25) that were anti-dilutive.

13. Trade and other receivables

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

	As at December 31, 2016	2015
Trade receivables	$ **17,774**	$ 7,800
Other receivables	**1,660**	396
Total trade and other receivables	$ **19,434**	$ 8,196

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

13. Trade and other receivables continued

The aging of the Company's trade and other receivables, based on invoice date and net of provisions, is as follows:

	As at December 31, 2016	2015
Less than 1 month	$ 5,777	$ 4,399
1 to 3 months	5,622	167
3 to 6 months	7,937	3,597
Over 6 months	98	33
Total trade and other receivables	**$ 19,434**	$ 8,196

Trade receivables are normally paid within 6 months from the date of billing. Overdue balances are reviewed regularly by senior management. The Company does not normally hold any collateral or other credit enhancements over its trade and other receivable balances. In December 2016, the Company entered into a settlement agreement with one of its major customers (the "Customers") pursuant to which 200 residential units and 40 parking spaces (collectively, the "240 Units") located in Ulannbaatar, Mongolia, are to be transferred to the Company as partial consideration for settling the outstanding trade receivables in the amount of $12,000, with the balance of the receivables, totalling $7,500, payable in cash by the Customer to the Company by March 31, 2017 (subsequently extended to May 10, 2017). As the title transfer on the agreement could not completed prior to December 31, 2016, the transaction cannot be completed and recorded in the Company's accounts until such titles are properly registered in the Company's name. The settlement agreement includes an option for the Company to return any unsold units back to the Customer, until September 30, 2017, at the same price per unit for immediate payment of the balance in cash. As of the date hereof, the title transfer registration in Mongolia has been completed for a material portion of the 240 Units but additional time will be required to finalize the administrative process for the registration of the remaining portion of the 240 Units due to the number of units involved, the Company has been working closely with the government authority to facilitate the process. To March 31, 2017, the Company has collected $3,478 from the Customer to settle the outstanding trade receivables and on March 27, 2017 entered into a deferral agreement to extend the payment due date on the remaining uncollected balance to May 10, 2017.

For the year ended December 31, 2016, the Company recorded a $2,641 loss provision on its trade and other receivables in other operating expenses (2015: $161). 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.

14. Inventories

The Company's inventories consist of the following amounts:

	As at December 31, 2016	2015
Coal stockpiles	$ 7,228	$ 9,606
Materials and supplies	21,355	22,656
Total inventories	**$ 28,583**	$ 32,262

Cost of sales for the year ended December 31, 2016 includes an impairment loss of $7,354 related to the Company's coal stockpile inventories (2015: $14,588). As at December 31, 2016, $321 of the Company's coal stockpile inventories are carried at their net realizable value (2015: $1,711).

An impairment of $675 was made on the surplus materials and suppliers inventories during the year ended December 31, 2015. These items were not expected to be utilized with the Company's existing mining fleet and, therefore, were adjusted to their net realizable value.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

15. Prepaid expenses and deposits

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

	As at December 31, 2016	2015
Vendor prepayments	$ 4,102	$ 25
Restricted cash balance	1	61
Other prepaid expenses and deposits	4,091	1,401
Total short and long term prepaid expenses and deposits	$ 8,194	$ 1,487

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	Non-depreciable assets	Total
Cost						
As at January 1, 2016	$ 344,832	$ 28,534	$ 72,194	$ 145,270	$ 28,564	$ 619,394
Additions	1,780	345	–	3,668	–	5,793
Disposals	(313)	(124)	–	–	–	(437)
As at December 31, 2016	$ 346,299	$ 28,755	$ 72,194	$ 148,938	$ 28,564	$ 624,750
Accumulated depreciation and impairment charges						
As at January 1, 2016	$ (222,482)	$ (26,772)	$ (42,056)	$ (93,733)	$ (11,866)	$ (396,909)
Depreciation for the year	(38,349)	(1,007)	(4,703)	(2,258)	–	(46,317)
Impairment charges	–	–	–	–	(1,152)	(1,152)
Eliminated on disposals	313	124	–	–	–	437
As at December 31, 2016	$ (260,518)	$ (27,655)	$ (46,759)	$ (95,991)	$ (13,018)	$ (443,941)
Carrying amount						
As at December 31, 2015	$ 122,350	$ 1,762	$ 30,138	$ 51,537	$ 16,698	$ 222,485
As at December 31, 2016	$ 85,781	$ 1,100	$ 25,435	$ 52,947	$ 15,546	$ 180,809

	Mobile equipment	Other operating equipment	Buildings and roads	Mineral properties	Non-depreciable assets	Total
Cost						
As at January 1, 2015	$ 341,942	$ 28,615	$ 72,194	$ 133,486	$ 30,753	$ 606,990
Additions	3,101	31	–	11,784	–	14,916
Disposals	(2,400)	(112)	–	–	–	(2,512)
Reclassifications	2,189	–	–	–	(2,189)	–
As at December 31, 2015	$ 344,832	$ 28,534	$ 72,194	$ 145,270	$ 28,564	$ 619,394
Accumulated depreciation and impairment charges						
As at January 1, 2015	$ (180,182)	$ (19,834)	$ (33,052)	$ (15,785)	$ (8,270)	$ (257,123)
Depreciation for the year	(40,374)	(2,243)	(5,304)	(1,285)	–	(49,206)
Impairment charges	(3,885)	(4,807)	(3,700)	(76,663)	(3,596)	(92,651)
Eliminated on disposals	1,959	112	–	–	–	2,071
As at December 31, 2015	$ (222,482)	$ (26,772)	$ (42,056)	$ (93,733)	$ (11,866)	$ (396,909)
Carrying amount						
As at December 31, 2014	$ 161,760	$ 8,781	$ 39,142	$ 117,701	$ 22,483	$ 349,867
As at December 31, 2015	$ 122,350	$ 1,762	$ 30,138	$ 51,537	$ 16,698	$ 222,485

16.1 Non-depreciable assets

The non-depreciable assets include the construction in progress and deposits on purchasing items of property, plant and equipment of $15,340 (2015: $16,492), which primarily relate to ordered but not yet delivered mobile equipment or mobile equipment delivered to the location of its intended use but not yet commissioned.

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

16. Property, plant and equipment continued

16.2 Pledge on items of property, plant and equipment

As at December 31, 2016, certain of the Company's property, plant and equipment of $3,678 (2015: nil) were pledged as security for a bank loan granted to the Company (Note 21).

16.3 Items of property, plant and equipment held under finance leases

As at December 31, 2016, certain of the Company's mobile equipment of $720 (2015: nil) were held under finance leases.

16.4 Impairment charges

For the year ended December 31, 2016, the Company recorded an impairment charges of $1,152 in respect of non-depreciable assets (2015: impairment charge of $92,651 to reduce various items of property, plant and equipment to their recoverable amounts). The impairments for the year ended December 31, 2015 related to the following items of property, plant and equipment:

- Mineral properties – the Company conducted an impairment test of the Ovoot Tolgoi Mine cash generating unit in view of the existence of the impairment indicator of continuing weakness in the Company's share price during the year ended December 31, 2015 and the fact that the market capitalization of the Company, as at December 31, 2015, was significantly less than the carrying value of its net assets. As a result of the impairment assessment, the Company recorded a $76,663 impairment charge in 2015. Refer to note 3.23 for details.

- Dry coal handling facility ("DCHF") – the Company conducted an extensive review of the DCHF in 2013 and the carrying value was reduced to $11,200 as at December 31, 2013, representing the estimated value of the rotary breaker facility, after the conclusion that the Company did not plan to either complete or use the balance of the DCHF in the foreseeable future. A second review has been performed on DCHF in the fourth quarter of 2015 related to the new mine plan and the Company determined that there was no plan to restart the DCHF project or to utilize the rotary breaker facility. As a result of the impairment assessment, the Company recorded an $8,507 impairment charge in 2015 to reduce the carrying value of the DCHF to $nil as at December 31, 2015.

- Other – the Company also recorded a write-off of $3,596 in the year ended December 31, 2015 related to construction in progress projects no longer anticipated to be put into use and an impairment of $3,885 related to unused mobile equipment.

17. Investment in a joint venture

The Company's investment consists of the following amounts:

	As at December 31, 2016	2015
Non-current investment in joint venture		
Investment in RDCC LLC	**$ 21,335**	$ 25,667
Total investment	**$ 21,335**	$ 25,667

The Company has a 40% interest in RDCC LLC, a joint venture. RDCC LLC has 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 for the exclusive use of third party coal transport companies. In October 2012, the concession agreement was structured as a 17-year build, operate and transfer agreement. The construction was completed in 2014 and operations commenced in the second quarter of 2015. On September 17, 2015, the Invest Mongolia Agency signed an amendment to the concession agreement with RDCC LLC to extend the exclusive right of ownership to 30 years.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

17. Investment in a joint venture continued

The movement of the Company's investment in RDCC LLC is as follows:

	Year ended December 31, 2016	2015
Balance, beginning of period	$ 25,667	$ 26,574
Funds advanced	–	143
Dividend received	(1,255)	–
Share of earnings of a joint venture	806	225
Share of other comprehensive loss of a joint venture	(3,883)	(1,275)
Balance, end of period	$ 21,335	$ 25,667

Summarized financial statement information of RDCC LLC is as follows (presented on a 100% basis of RDCC LLC in which the Company has a 40% investment):

	As at December 31, 2016	2015
Current assets	$ 592	$ 2,029
Non-current assets	38,842	50,243
Total assets	$ 39,434	$ 52,272
Current liabilities	$ 400	$ 2,003
Total liabilities	$ 400	$ 2,003

	Year ended December 31, 2016	2015
Revenue	$ 5,007	$ 2,631
Gross profit margin	2,575	932
Other operating and finance costs	(261)	1
Profit before tax	2,314	616
Net profit	$ 2,016	$ 562
Other comprehensive loss	$ (9,708)	$ (3,186)
Total comprehensive loss	$ (7,692)	$ (2,624)

18. Trade and other payables

Trade and other payables of the Company primarily 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, based on invoice date, is as follows:

	As at December 31, 2016	2015
Less than 1 month	$ 14,640	$ 9,465
1 to 3 months	2,493	3,282
3 to 6 months	2,648	6,075
Over 6 months	23,847	12,095
Total trade and other payables	$ 43,628	$ 30,917

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

18. Trade and other payables continued

Included in trade and other payables as at December 31, 2015 were amounts due to related parties which are further disclosed in Note 29, the aging analysis of the trade and other payables due to related parties, based on invoice date, was as follows:

		As at December 31, 2015
Less than 1 month	$	274
1 to 3 months		54
3 to 6 months		192
Over 6 months		8,105
Total trade and other payables	$	8,625

Trade and other payables as at December 31, 2016 included payables resulting from civil claims:

18.1 Settlement of Claim by Former Chief Executive Officer

On June 30, 2015, the Company was served with a Notice of Civil Claim filed by the Company's former President and Chief Executive Officer, Alexander Molyneux ("Mr. Molyneux"), in the British Columbia Supreme Court, Canada. Mr. Molyneux acted as the Company's President (from April 2009) and Chief Executive Officer (from October 2009) until September 2012, when the Company terminated his employment. The claim, seeking damages in excess of $1,000, related to alleged breaches of Mr. Molyneux's employment agreement by the Company. In addition to the Company, Turquoise Hill, the Company's largest shareholder at the time of Mr. Molyneux's employment, was also named as a defendant in the claim. The Company filed a response to civil claim and a counterclaim in September 2015.

Mr. Molyneux's claim, and the counterclaim by the Company, have been settled by a payment by the Company to Mr. Molyneux of the sum of $290, without admission of liability by either party. As a term of the settlement, the Company and Mr. Molyneux executed mutual general releases, and the action and counterclaim were dismissed as against all parties by consent without court costs payable to any party, effective on November 25, 2016.

18.2 Settlement of Lawsuit Notice from a Former Fuel Supplier

On January 20, 2017, the Company announced that SouthGobi Sands LLC ("SGS"), a subsidiary of the Company, had received a lawsuit notice from the Khan-Uul District Civil Court of First Instance in Mongolia (the "DC Court") in relation to a claim from MTLLC, a former fuel supplier of SGS, for MNT22.2 billion (approximately $8,900) consisting of MNT14.6 billion (approximately $5,800) of outstanding fuel supply payments and MNT7.6 billion (approximately $3,100) of late payment penalties and associated interest costs.

SGS disputed the amount claimed by MTLLC in the proceedings before the DC Court and filed an application with the DC Court to dismiss the litigation, on the basis that the contract required an arbitration process prior to the initiation of court proceedings. On January 25, 2017, the Company announced that the DC Court had dismissed the litigation pending the arbitration process.

Following SGS' successful challenge to the authority of the DC court to hear the matter, the Company signed a settlement agreement with MTLLC on February 10, 2017, pursuant to in which the outstanding amount of $7,928 will be settled in equal monthly installments of $1,982 from March to June 2017.

19. Provision for court case penalty

In 2014, the Company was subject to several investigations by Mongolia's Independent Authority Against Corruption (the "IAAC") regarding allegations of breaches of Mongolia's anti-corruption laws (the "Anti-Corruption Case"), and tax evasion and money laundering (the "Tax Evasion Case").

While the IAAC has not made any formal accusations against any current or former employee of the Company or the Company under the Anti-Corruption Case, administrative penalties were imposed on certain of the Company's Mongolian assets in connection with the investigation, including certain funds held in bank accounts in Mongolia totaling $1,200 (the "Restricted Funds"). The Company has been informed that the Anti-Corruption Case has been suspended; however, it has not received formal notice that the investigation is completed.

With respect to the Tax Evasion Case, on December 30, 2014, the Capital City Prosecutor's Office (Ulaanbaatar, Mongolia) dismissed the allegations of money laundering as not having been proven during the investigation; however, proceedings in respect of tax evasion by former employees of the Company proceeded and culminated in February 2015, when the Company received the written verdict (the "Tax Verdict") of Mongolian Second District Criminal Court. The Tax Verdict pronounced the three former employees of SGS guilty and declared SGS to be financially liable as a "civil defendant" for a penalty (the "Tax Penalty") of MNT35.3 billion (approximately $18,200 on February 1, 2015). Following the refusal of the Supreme Court of Mongolia to hear the case on appeal in June 2015, the Tax Verdict entered into force. The Tax Verdict is, however, not immediately payable and enforceable against SGS absent further actions prescribed by the laws of Mongolia. However, the Company made a corresponding provision for the court case penalty of $18,000 in the second quarter of 2015 given the Tax Verdict has entered into force.

On October 6, 2015, the Company was informed by its Mongolian banks (where the Restricted Funds were held) that they had received an official request from the Court Decision Implementing Agency of Mongolia ("CDIA") to transfer the Restricted Funds according to the court decision. $1,200 was transferred to CDIA from the frozen bank accounts in October and November 2015.

Following the submission by the Company of various proposals to resolve the dispute giving rise to the Tax Verdict, in May 2016, the Resolution 258 of the Government of Mongolia was issued, which approved the Company's proposal to partially settle the Tax Penalty by way of certain cash payments in 2016 and 2017 and by the Company performing certain mining operations at the Tavan Tolgoi deposit on behalf of Erdenes Tavan Tolgoi JSC ("Erdenes"). Subsequent to this Resolution, the Company made cash payments of $2,406 during 2016 as a partial settlement of the Tax Penalty.

In compliance with the Resolution 258, in November 2016, the Company entered into an agreement with Erdenes under which the Company agreed to perform certain mining operations equivalent to MNT20.3 billion (approximately $8,135) in the West Tsankhi section of the Tavan Tolgoi deposit during the period November 2016 to February 2017. As at December 31, 2016, the Company had performed mining operations consisting of drilling and blasting of rock mass, stripping and loading topsoil, selective excavation and loading coal, and creating overburden stockpiles at the Tavan Tolgoi deposit equivalent to MNT5.2 billion (approximately $2,074).

Subsequent to December 31, 2016, the Company has completed the mining operations at the Tavan Tolgoi deposit equivalent to MNT20.3 billion (approximately $8,135) as set out in the agreement with Erdenes.

The Company has provided $9,074 for the court case penalty at December 31, 2016. The decrease from $18,049 as at June 30, 2015 is as a result of subsequent transfers from frozen bank accounts of $1,200, additional cash payments by the Company of $2,406, the provision of mining services at the Tavan Tolgoi deposit of $2,074 (Note 8) and the foreign exchange adjustments.

The Company is required to make further cash payments of $3,013 in 2017 to complete repayment of the balance of the penalty owing.

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

19. Provision for court case penalty continued

As described above, the Company is working with the relevant authorities in Mongolia to resolve the dispute giving rise to the tax verdict in a manner that is appropriate having regard to the Company's limited financial resources and supportive of a positive environment for foreign investment in Mongolia. Should the Company fail to meet the terms of the agreed repayment plan and to receive a discharge of the judgment from the applicable Mongolian court, this may result in an event of default under the CIC Convertible Debenture and CIC would have the right to declare the full principal and accrued interest owing thereunder immediately due and payable. Such an event of default under the CIC Convertible Debenture or the Company's inability to pay the penalty could result in voluntary or involuntary proceedings involving the Company, including bankruptcy.

20. Deferred revenue

At December 31, 2016, the Company has deferred revenue of $29,849, which represents prepayments for coal sales from customers (2015: $11,683).

Included in deferred revenue is amount prepaid by First Concept, who served a notice of arbitration (the "Notice") on SGS of $11,500 at December 31, 2016 (2015: $11,500), details are further disclosed in Note 32.8.

21. Interest-bearing borrowings

The Company's interest-bearing borrowings consist of the following amounts:

	As at December 31,	
	2016	2015
Turquoise Hill Loan Facility (i)	$ 2,881	$ 3,954
Short-term bridge loan (ii)	3,425	4,951
Bank loan (iii)	2,026	–
Finance lease payables (iv)	547	–
Total interest-bearing borrowings	**$ 8,879**	$ 8,905

(i) Turquoise Hill Loan Facility

On May 25, 2014, the Company announced it obtained a loan from Turquoise Hill in the form of a $10,000 revolving credit facility to meet its short term working capital requirements (the "TRQ Loan"). The key commercial terms of the facility were: an original maturity date of August 30, 2014 (subsequently extended as described below); an interest rate of one month US dollar LIBOR Rate in effect plus 11% per annum; a commitment fee of 35% of interest rate payable quarterly in arrears on undrawn principal amount of facility and a front end fee of $100.

During 2014 and 2015, the due date of the TRQ Loan, was extended several times and the maximum amount of the facility was reduced to $3,800.

On May 16, 2016, the Company and Turquoise Hill entered into the May 2016 Deferral Agreement, whereby Turquoise Hill agreed to a limited deferral of repayment of all remaining amounts and obligations owing under the TRQ Loan to December 29, 2017 in accordance with the schedule of repayment set out below:

- The Company agreed to effect monthly repayments on the last business day of each month in an amount of (i) $150 per month from May 2016 to April 2017, (ii) $200 per month starting from May 2017 to December 2017 (the payments in (i) and (ii), the "Repayments"), at which time all remaining obligation will become due.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Expressed in thousands of U.S. Dollars and shares in thousands, unless otherwise indicated)

21. Interest-bearing borrowings continued

(i) Turquoise Hill Loan Facility continued

- In the event that the Company fails to make any one of the Repayments in its entirety on or before the dates set out above, then the Company shall be in automatic and irremediable default of the obligations thereunder and under the TRQ Loan, shall immediately and irremediably lose all benefits of the May 2016 Deferral Agreement, and all then outstanding obligations shall become immediately due and payable to Turquoise Hill; and
- Interest shall continue to accrue on all outstanding obligations at the 12-month US dollar LIBOR rate.

Unless otherwise agreed by Turquoise Hill, under certain circumstances, including the non-payment of interest amounts as the same become due, amounts outstanding under the TRQ Loan may be accelerated. Bankruptcy and insolvency events with respect to the Company or its material subsidiaries will result in an automatic acceleration of the indebtedness under the TRQ Loan. Subject to notice and cure periods, certain events of default under the TRQ Loan will result in acceleration of the indebtedness under such loan at the option of Turquoise Hill.

As at December 31, 2016, the outstanding principal and accrued interest under this facility amounted to $2,200 and $681, respectively (at December 31, 2015, the outstanding principal and accrued interest under this facility amounted to $3,400 and $554, respectively).

(ii) Short-term Bridge Loan

On October 27, 2015, the Company executed a $10,000 bridge loan agreement with an independent Asian based private equity fund. The interest rate is 8% per annum with interest payable upon the repayment of loan principal.

The Company repaid the first tranche of the short-term bridge loan with interest of $5,042 up to August 11, 2016. During June and July 2016, the Company drew the second tranche of $5,038, of which $1,504 has been matured in March 2017 and $3,534 will mature in April 2017. In December 2016, $1,454 was repaid for the short-term bridge loan and further $1,796 and $1,597 was subsequently repaid in January 2017 and March 2017, respectively.

As at December 31, 2016, the outstanding balance for the short-term bridge loan was $3,297 (December 31, 2015: $4,885) and the Company owed accrued interest of $128 (December 31, 2015: $66). A loan arrangement fee of 5% of the loan principal drawn was charged, totaling $252 for the loans drawn during June and July 2016 and amortized throughout the loan term. For the year ended December 31, 2016, $159 of loan arrangement fee was amortized (2015: nil).

Under certain circumstances, including the non-payment of interest amounts as the same become due, amounts outstanding under the short-term bridge loan may be accelerated. Bankruptcy and insolvency events with respect to the Company or its material subsidiaries will result in an automatic acceleration of the indebtedness under the short-term bridge loan. Subject to notice and cure periods, certain events of default under the short-term bridge loan will result in acceleration of the indebtedness under the short-term bridge loan at the option of the lender.

(iii) Bank Loan

On May 6, 2016, the Company entered into a $2,000 loan agreement with a Mongolian bank. The key commercial terms of the loan are as follows:

- Maturity date of May 6, 2017;
- Interest rate of 15.8% per annum and payable monthly; and
- Certain items of property, plant and equipment in the amount of $3,678 were pledged.

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

21. Interest-bearing borrowings continued

(iii) Bank Loan continued

As at December 31, 2016, the outstanding balance for the bank loan was $2,000 (2015: nil) and the Company owed accrued interest of $26 (2015: nil).

(iv) Finance Leases Payable

The Company leases certain of its mobile equipment for daily operations. These leases are classified as finance leases and have remaining lease terms ranging from 2 to 5 years.

At December 31, 2016, the total future minimum lease payments under finance leases and their present values were as follows:

	Minimum lease payments As at December 31,		Present value of minimum lease payments As at December 31,	
	2016	2015	**2016**	2015
Amounts payable:				
Within one year	**$ 152**	$ –	**$ 122**	$ –
In the second year	**152**	–	**131**	–
In the third to fifth years, inclusive	**314**	–	**294**	–
Total minimum finance lease payments	**$ 618**	$ –	**$ 547**	$ –
Future finance charges	**(71)**	–		
Total net lease finance payables	**$ 547**	$ –		
Portion classified as current liabilities	**(122)**	–		
Non-current portion	**$ 425**	$ –		

22. Convertible debenture

22.1 Key commercial terms

On November 19, 2009, the Company issued a convertible debenture to a wholly owned subsidiary of CIC for $500,000. The convertible debenture bears interest at 8.0% per annum (6.4% payable semi-annually in cash and 1.6% payable annually in the Company's shares) and has a maximum term of 30 years. The convertible debenture is secured by a first ranking charge over the Company's assets, including shares of its material subsidiaries. An event of default on the convertible debenture can be triggered as a result of certain encumbrances on the Company's assets (refer to Note 32.2). During 2010, the Company exercised a right within the debenture to call and convert $250,000 of the debenture for 21,471 common shares. Following the conversion the outstanding principal balance was $250,000 and has remained unchanged at that balance to December 31, 2016.

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 common 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. An event of default on the convertible debenture can be triggered as a result of certain encumbrances on the Company's assets (Note 32.2).
- Conversion price – The conversion price is set as the lower of CAD$11.88 or the 50-day VWAP at the date of conversion, with a floor price of CAD$8.88 per share.

22. Convertible debenture continued

22.1 Key commercial terms continued

- CIC's conversion right – CIC has the right to convert the convertible debenture, in whole or in part, into common shares twelve months after the date of issue.
- Company's normal conversion right – After sixty months from the issuance date, and when the conversion price is greater than CAD$10.66, the Company is entitled to force 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 convertible debenture 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 of Directors. The Company currently has eight Board of Directors 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.
- Pre-emption rights – While the convertible debenture 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 convertible debenture is outstanding. The pre-emption rights will not apply to new shares issued pursuant to pro-rata public equity offerings made to all shareholders, exercise of stock options and shares issued to achieve a 25% public float.
- Right of first offer – While a portion of the convertible 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 Turquoise Hill's ownership stake in the Company.
- Registration rights – CIC has registration rights under applicable Canadian provincial securities laws in connection with the common shares issuable upon conversion of the convertible debenture.

22.2 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 Company's common share price, the risk-free rate of return, expected volatility of the Company's common share price, forward foreign exchange rate curves (between the CAD$ and U.S. Dollar) and spot foreign exchange rates.

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

22. Convertible debenture continued

22.3 Valuation assumptions

The specific terms and assumptions used in the Company's valuation models are as follows:

	As at December 31, 2016	2015
Floor conversion price	**CAD$8.88**	CAD$8.88
Ceiling conversion price	**CAD$11.88**	CAD$11.88
Common share price	**CAD$0.27**	CAD$0.39
Historical volatility	**79%**	74%
Risk free rate of return	**2.23%**	2.03%
Foreign exchange spot rate (CAD$ to U.S. Dollar)	**0.74**	0.72
Forward foreign exchange rate curve (CAD$ to U.S. Dollar)	**0.74 – 0.77**	0.72 – 0.74

22.4 Presentation

Based on the Company's valuation as at December 31, 2016, the fair value of the embedded derivatives decreased by $217 compared to December 31, 2015. The decrease was recorded as finance income for the year ended December 31, 2016.

For the year ended December 31, 2016, the Company recorded interest expense of $21,279 related to the convertible debenture as a finance cost (2015: $20,549). 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 accretion 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, 2016	2015
Balance, beginning of year	**$ 108,659**	$ 95,187
Interest expense on convertible debenture	**21,279**	20,549
Decrease in fair value of embedded derivatives	**(217)**	(1,077)
Interest paid	**(12,131)**	(6,000)
Balance, end of year	**$ 117,590**	$ 108,659

The convertible debenture balance consists of the following amounts:

	As at December 31, 2016	2015
Current convertible debenture		
Interest payable	**$ 25,597**	$ 16,671
Non-current convertible debenture		
Debt host	**91,453**	91,231
Fair value of embedded derivatives	**540**	757
	91,993	91,988
Total convertible debenture	**$ 117,590**	$ 108,569

22.5 Interest deferral and settlement

On July 13, 2016, the Company executed a deferral agreement with CIC which covered outstanding deferred cash interest obligations and associated costs of $18,835 as of July 13, 2016 and the cash interest payment of $8,066 due on November 19, 2016. Pursuant to the deferral agreement, the Company originally agreed to repay $1,277 to $1,390 monthly from July 19 to November 19, 2016 and repay $20,653 on December 19, 2016. As a consideration for the deferred payments, the Company agreed to pay a deferral fee at a rate of 6.4% per annum on the deferred amount to CIC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

22. Convertible debenture continued

22.5 Interest deferral and settlement continued

In November 2016, the Company and CIC agreed to delay the share issuance portion of the interest settlement of $4,000, subsequently the shares of $4,000 were issued to CIC on January 11, 2017.

On December 29, 2016, the Company executed a new deferral agreement ("December 2016 Deferral Agreement") with CIC for a revised repayment schedule on the $20,653 of cash interest and associated costs originally due on December 19, 2016 ("December 2016 Deferral Amounts"). The key repayment terms of the December 2016 Deferral Agreement are: (i) the Company is required to repay $6,786 of the cash interest and associated deferral fee costs in five monthly amounts during the period from December 2016 to April 2017; (ii) the Company is required to repay $14,320 of cash interest and associated costs on May 19, 2017.

Under certain conditions, including the non-payment of interest amounts as the same become due, amounts outstanding under the CIC Convertible Debenture may be accelerated. Bankruptcy and insolvency events with respect to the Company or its material subsidiaries will result in an automatic acceleration of the indebtedness under the CIC Convertible Debenture. Subject to notice and cure periods, certain events of default under the CIC Convertible Debenture will result in acceleration of the indebtedness under such debenture at the option of CIC. Such other events of default include, but are not limited to, non-payment, breach of warranty, non-performance of obligations under the CIC Convertible Debenture, default on other indebtedness and certain adverse judgments.

23. Decommissioning liability

At December 31, 2016, the decommissioning liability primarily relates to reclamation and closure costs of the Company's Ovoot Tolgoi Mine.

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, 2016 totaled $7,271 (2015: $7,838). The estimated future reclamation and closure costs are inflated using an estimated inflation rate of 1.9% (2015: 2.2%) and discounted at 8.4% per annum (2015: 9.8% per annum) to determine the year end decommissioning liability. The settlement of the decommissioning liability will occur through to 2030.

The movement in the decommissioning liability during the years ended December 31, 2016 and 2015 were as follows:

	Year ended December 31,	
	2016	2015
Balance, beginning of year	**$ 3,149**	$ 2,704
Adjustments	**1,044**	338
Accretion	**95**	107
Balance, end of year	**$ 4,288**	$ 3,149

24. Equity

24.1 Share capital

The Company has authorized an unlimited number of common and preferred shares with no par value. At December 31, 2016, the Company had 257,698 common shares outstanding (2015: 257,683) and no preferred shares outstanding (2015: nil).

During 2015, the Company completed the private placements for the issue of 16,619 common shares for net proceeds of $6,580 and issued 11,958 common shares to settle the $4,000 November 19, 2015 share interest payment.

During 2015, the Company entered into a private placement with Novel Sunrise. On March 3, 2015 pursuant to the private placement agreement Novel Sunrise subscribed for an initial tranche of 10,131 mandatory convertible units for subscription proceeds of $3,500. Each mandatory convertible unit issued to Novel Sunrise in the initial tranche is convertible on a one for one basis into a Common Share of the Company, resulting in a deemed issue price of CAD$0.432 per Common Share. On April 23, 2015, the mandatory convertible units were converted into 10,131 Common Shares in the Company.

24.2 Accumulated deficit and dividends

At December 31, 2016, the Company has accumulated a deficit of $1,095,788 (2015: $1,034,942). No dividend has been paid or declared by the Company since inception.

25. Share-based payments

25.1 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 Company is authorized to issue stock options for a maximum of 10% of the issued and outstanding common shares pursuant to the stock option plan. The stock option plan permits the Board of Directors of the Company to set the terms for each stock option grant; however, the general terms of stock options granted under the 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.

For the year ended December 31, 2016, the Company granted 750 stock options (2015: 1,139) to officers, employees, directors and other eligible persons at exercise prices ranging from CAD$0.25 to CAD$0.33 (2015: exercise prices ranging from CAD$0.29 to CAD$0.92) and expiry dates ranging from August 26, 2021 to November 16, 2021 (2015: expiry dates ranging from April 1, 2020 to December 14, 2020). The weighted average fair value of the options granted in the year ended December 31, 2016 was estimated at $0.09 (CAD$0.12) (2015: $0.23, CAD$0.29) per option at the grant date using the Black-Scholes option pricing model.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

25. Share-based payments continued

25.1 Stock option plan continued

The weighted average assumptions used for the Black-Scholes option pricing model were as follows:

	Year ended December 31, 2016	2015
Risk free interest rate	**0.94%**	0.71%
Expected life	**3.2 years**	3.2 years
Expected volatility(i)	**59%**	80%
Expected dividend per share	**$ nil**	$ nil

(i) Expected volatility has been calculated based on historical volatility of the Company's publicly traded shares over a period equal to the expected life of the options.

A share-based compensation expense of $53 for the options granted in the year ended December 31, 2016 (2015: $218) will be amortized over the vesting period, of which $7 was recognized in the year ended December 31, 2016 (2015: $72).

The total share-based compensation expenses for the year ended December 31, 2016 was $48 (2015: $254). Share-based compensation expense of $58 (2015: $199) has been allocated to administration expenses, share-based compensation recovery of $2 (2015: share-based compensation expense of $13) has been allocated to evaluation and exploration expenses and share-based compensation recovery of $8 (2015: share-based compensation expense of $42) has been allocated to cost of sales.

25.2 Outstanding stock options

The option transactions under the stock option plan are as follows:

	Year ended December 31, 2016		Year ended December, 2015	
	Number of options	Weighted average exercise price (CAD$)	Number of options	Weighted average exercise price (CAD$)
Balance, beginning of year	**2,399**	**$ 1.43**	3,053	$ 3.63
Options granted	**750**	**0.32**	1,139	0.59
Options exercised	**–**	**–**	(12)	0.65
Options forfeited	**(324)**	**0.84**	(953)	0.74
Options expired	**(915)**	**2.44**	(828)	9.18
Balance, end of year	**1,910**	**$ 0.61**	2,399	$ 1.43

The weighted average share price at the date of exercise for share options exercised during the year ended December 31, 2015 was CAD$1 per share.

The stock options outstanding and exercisable as at December 31, 2016 are as follows:

	Options Outstanding			Options Exercisable		
Exercise price (CAD$)	Options outstanding	Weighted average exercise price (CAD$)	Weighted average remaining contractual life (years)	Options outstanding and exercisable	Weighted average exercise price (CAD$)	Weighted average remaining contractual life (years)
$0.25 – $0.65	**1,640**	**$ 0.36**	**4.13**	**879**	**$ 0.38**	**3.53**
$0.92 – $1.92	**218**	**1.17**	**2.67**	**108**	**1.42**	**2.08**
$6.16	**52**	**6.16**	**0.22**	**52**	**6.16**	**0.22**
	1,910	**$ 0.61**	**3.85**	**1,039**	**$ 0.78**	**3.21**

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

26. Reserves

26.1 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 25.

The share option reserve transactions for the years ended December 31, 2016 and 2015 are as follows:

	Year ended December 31,	
	2016	2015
Balance, beginning of year	**$ 52,292**	$ 52,041
Exercise of stock options, net of redemptions	**–**	(3)
Share-based compensation charged to operations	**48**	254
Balance, end of year	**$ 52,340**	**$ 52,292**

27. Capital risk management

The Company's capital risk management 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, 2016, the Company's capital structure consists of convertible debt (Note 22), interest-bearing borrowings (Note 21) and the equity of the Company (Note 24). 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, 2016, 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, 2016, the Company had cash of $966.

Based on the Company's forecasts for the year ending December 31, 2017, the Company is unlikely to have sufficient capital resources and does not expect to generate sufficient cash flows from mining operations in order to satisfy its ongoing obligations and future contractual commitments, including cash interest payments due on the CIC Convertible Debenture, the short-term bridge loan, the TRQ Loan and the bank loan. Therefore, the Company is actively seeking additional sources of financing to continue operating and meet its objectives (Note 1).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

28. Financial instruments and fair value measurements

28.1 Categories of financial instruments

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

	As at December 31, 2016	2015
Financial assets		
Loans-and-receivables		
Cash	**$ 966**	$ 377
Trade and other receivables (Note 13)	**19,434**	8,196
Total financial assets	**$ 20,400**	$ 8,573
Financial liabilities		
Fair value through profit or loss		
Convertible debenture – embedded derivatives (Note 22)	**$ 540**	$ 757
Other-financial-liabilities		
Trade and other payables (Note 18)	**43,628**	30,917
Interest-bearing borrowings (Note 21)	**8,879**	8,905
Convertible debenture – debt host (Note 22)	**117,050**	107,902
Total financial liabilities	**$ 170,097**	$ 148,481

28.2 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 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 22) is determined using a Monte Carlo simulation. None of the fair value change in the embedded derivatives for the year ended December 31, 2016 is related to a change in the credit risk of the convertible debenture. All of the change in fair value is associated with changes in market conditions.

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

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

- Level 1 fair value measurements are those derived from quoted prices in active markets for identical assets or liabilities.

- Level 2 fair value measurements are those derived from inputs other than quoted prices included within Level 1, that are observable either directly or indirectly.

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

28. Financial instruments and fair value measurements continued

28.2 Fair value continued

- Level 3 fair value measurements are those derived from valuation techniques that include inputs that are not based on observable market data.

Recurring measurements		Level 1		Level 2		Level 3		Total
				As at December 31, 2016				
Financial liabilities at fair value								
Convertible debenture – embedded derivatives	$	–	$	540	$	–	$	540
Convertible debenture – debt host		–		217,195		–		217,195
Total financial liabilities at fair value	$	–	$	217,735	$	–	$	217,735

Recurring measurements		Level 1		Level 2		Level 3		Total
				As at December 31, 2015				
Financial liabilities at fair value								
Convertible debenture – embedded derivatives	$	–	$	757	$	–	$	757
Convertible debenture – debt host		–		166,010		–	$	166,010
Total financial liabilities at fair value	$	–	$	166,767	$	–	$	166,767

There were no transfers between Level 1, 2 and 3 for the year ended December 31, 2016.

28.3 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 of the Company 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.

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

		As at December 31, 2016		2015
Increase/decrease in foreign exchange rate				
+5%	$	24	$	14
-5%	$	(24)	$	(14)

Interest rate risk

The Company is exposed to interest rate risk on the variable rate of interest earned on its cash. However, the rate of interest earned on these instruments is below 3%; therefore, the interest rate risk is not significant.

Except for the interest-bearing borrowing from the TRQ Loan (Note 21), the Company's short-term bridge loan (Note 21), the bank loan (Note 21) and CIC Convertible Debenture (Note 22) accrue interests at fixed rates where the Company is not exposed to interest rate risk. The Company has not entered into any derivative instruments to manage interest rate fluctuations, however, management closely monitors interest rate exposure and the risk exposure is limited.

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

28. Financial instruments and fair value measurements continued

28.3 Financial risk management objectives and policies continued

Credit risk

The Company is exposed to credit risk associated with its cash 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 arises from default of the counterparty. The Company limits its exposure to counterparty credit risk on cash by only dealing with financial institutions with high credit ratings.

The Company seeks to manage its credit risk on trade and other receivables by trading with third party customers it considers to be creditworthy. 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.

Liquidity risk

Liquidity risk is the risk that the Company will not be able to settle or manage its obligations associated with financial liabilities. Based on the Company's forecasts for the year ended December 31, 2016, the Company is unlikely to have sufficient capital resources and does not expect to generate sufficient cash flows from mining operations in order to satisfy its ongoing obligations and future contractual commitments, including cash interest payments due on the CIC Convertible Debenture. Therefore, the Company is actively seeking additional sources of financing to continue operating and meet its objectives (Note 1).

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	Total
As at December 31, 2016			
Trade and other payables	**$ 43,628**	**$ –**	**$ 43,628**
Interest-bearing borrowings(i)	**7,477**	**1,296**	**8,773**
Convertible debenture – cash interest(i)	**27,696**	**8,000**	**35,696**
	$ 78,801	**$ 9,296**	**$ 88,097**
As at December 31, 2015			
Trade and other payables	$ 30,917	$ –	$ 30,917
Interest-bearing borrowings	687	9,079	9,766
Convertible debenture – cash interest	22,182	8,000	30,182
	$ 53,786	$ 17,079	$ 70,865

(i) The expected undiscounted cash flows of the above noted financial liabilities include the cash interest payment on the interest-bearing borrowings and convertible debenture for the year ended December 31, 2016. Refer to Note 21 and Note 22 for the terms of the interest-bearing borrowings and convertible debenture, respectively.

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.

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

28. Financial instruments and fair value measurements continued

28.3 Financial risk management objectives and policies continued

Commodity price risk continued

The Company enters into sales contracts with its customers to manage the risk of off-take of coal at prevailing market prices by, in most cases, entering into short term 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.

29. Related party transactions

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

Name	Country of incorporation	% equity interest As at December 31, 2016	2015
SouthGobi Resources (Hong Kong) Limited	Hong Kong	**100%**	100%
SGS	Mongolia	**100%**	100%
SGQ Coal Investment Pte. Ltd.	Singapore	**100%**	100%
SouthGobi Trading (Beijing) Co., Ltd.*	China	**100%**	100%
Inner Mongolia SouthGobi Energy Co., Ltd.	China	**100%**	–

* SouthGobi Trading (Beijing) Co., Ltd. was registered as a wholly-foreign-owned enterprise under law of China.

During the year ended December 31, 2015, the Company had related party transactions with the following companies related by way of directors or shareholders in common:

- Turquoise Hill – Prior the completion of the Novel Sunrise share purchase agreement (the "Novel SPA") and private placement with Novel Sunrise on April 23, 2015, Turquoise Hill was the Company's immediate parent company. Turquoise Hill's shareholding at April 1, 2015 was approximately 48%, it further declined to just under 20% by December 31, 2015 and to nil at December 31, 2016. Turquoise Hill provided various administrative services to the Company on commercial terms.

- Rio Tinto – Prior to the completion of the Novel SPA and private placement with Novel Sunrise on April 23, 2015, Rio Tinto was the Company's ultimate parent company. The Company recovered administration and other costs incurred on behalf of Rio Tinto on a cost-recovery basis. Rio Tinto recovered from the Company the costs of salaries and benefits of employees assigned to work for the Company and recovers legal and professional fees from the Company in respect of the internal and tripartite committees.

- Turquoise Hill Resources Singapore Pte. Ltd. ("Turquoise Hill Singapore") – Turquoise Hill Singapore is a private company 100% owned by Turquoise Hill. Turquoise Hill Singapore provided information technology and other related services to the Company on a cost-recovery basis.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

29. Related party transactions continued

29.1 Related party expenses

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

		Year ended December 31, 2015
Corporate administration	$	463
Salaries and benefits		216
Finance costs		409
Related party expenses	$	1,088

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

		Year ended December 31, 2015
Turquoise Hill	$	409
Rio Tinto		261
Turquoise Hill Singapore		418
Related party expenses	$	1,088

29.2 Related party liabilities

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

		As at December 31, 2015
Amounts payable to Rio Tinto	$	8,044
Accounts payable to Turquoise Hill Singapore		567
Accounts payable to Turquoise Hill		3,968
Total liabilities due to related parties	$	12,579

29.3 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,			
		2016		2015
Salaries, fees and other benefits	**$**	**1,265**	$	1,434
Share-based compensation		**66**		166
Total remuneration	**$**	**1,331**	$	1,600

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

30. Supplemental cash flow information

30.1 Non-cash financing and investing activities

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

	Year ended December 31, 2016	2015
Amortization of deferred stripping being capitalized	**$ 1,366**	$ 5,610
Addition to decommissing liability (Note 23)	**1,044**	338
Settlement of court case penalty by mining service receivable from Erdenes (Note 19)	**2,074**	–
Purchase of vehicles financed by loans	**578**	–
Convertible debenture interest settlement in shares	**–**	4,000
Gain on waiver of loan from Turquoise Hill	**–**	200
Total non-cash financing and investing activities	**$ 5,062**	$ 10,148

30.2 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, 2016	2015
Increase in inventories	**$ 608**	$ (2,758)
Increase in trade and other receivables	**(16,293)**	(8,204)
Decrease/(increase) in prepaid expenses and deposits	**(6,707)**	2,705
Decrease in provision for court case penalty	**(2,406)**	(1,580)
Increase in trade and other payables	**12,178**	13,651
Increase/(decrease) in deferred revenue	**17,455**	(215)
Net change in non-cash working capital items	**$ 4,835**	$ 3,599

31. Commitments for expenditure

The Company's commitments for expenditure that have not been disclosed elsewhere in the consolidated financial statements are as follows:

	Within 1 year	2-3 years	Over 3 years	Total
As at December 31, 2016				
Capital expenditure commitments	**$ 1,897**	**$ –**	**$ –**	**$ 1,897**
Operating expenditure commitments	**6,546**	**700**	**213**	**7,459**
Commitments	**$ 8,443**	**$ 700**	**$ 213**	**$ 9,356**
As at December 31, 2015				
Capital expenditure commitments	$ 7,328	$ 7,308	$ –	$ 14,636
Operating expenditure commitments	8,530	1,287	645	10,462
Commitments	$ 15,858	$ 8,595	$ 645	$ 25,098

Pursuant to an Investment and Collaboration Agreement dated April 2, 2016, the Company contracted with a third party to construct and operate a wash plant at the Ovoot Tolgoi mine site. Under the terms of the agreement the other party is responsible for all capital costs related to the construction of the facility and to operate the facility during the initial term of the contract, which is until 10 million tonnes of coal is washed. Upon reaching 10 million tonnes of coal washed, the ownership of the wash plant will pass to the Company. Payment for the coal washing will be Renminbi 25 per tonne covering a set amount per tonne for operating costs and a set amount per tonne as a reimbursement of the capital costs. As such, upon completion of the construction of the wash plant, it is expected that the agreement will be accounted for as a finance lease. Management is currently in discussions with the third party contractor to renegotiate certain terms of the contract prior to the commencement of commissioning.

32. Contingencies

32.1 Internal investigations

Through its Audit Committee (comprised solely of independent directors), the Company conducted an internal investigation into possible breaches of law, internal corporate policies and codes of conduct arising from allegations raised in the context of investigations by Mongolian authorities. The former Chair of the Audit Committee also participated in a tripartite committee, comprised of the Audit Committee Chairs of the Company and Turquoise Hill and a representative of Rio Tinto, focused on the investigation of a number of those allegations, including possible violations of anti-corruption laws. The tripartite committee substantially completed the investigative stage of its activities during the third quarter of 2013. There have been no significant developments in respect of the internal investigations since the completion of the investigation phase during the third quarter of 2013.

The investigations referred to above could result in one or more Mongolian, Canadian, United States or other governmental or regulatory agencies taking civil or criminal action against the Company, its affiliates or its current or former employees. The likelihood or consequences of such an outcome are unclear at this time but could include financial or other penalties, which could be material, and which could have a material adverse effect on the Company, the outcome of which is unclear at this time but could have a material adverse effect on the Company.

In the opinion of management of the Company, at December 31, 2016 a provision for this matter is not required.

32.2 Mongolian IAAC Investigation

In the first quarter of 2013, the Company was subject to orders imposed by the IAAC which placed restrictions on certain of the Company's Mongolian assets. The orders were imposed on the Company in connection with the IAAC's investigations of the Company as described above under "Provision for court case penalty" and continued to be enforced by the Mongolian State Investigation Office. The restrictions on the assets were reaffirmed in the Tax Verdict and form part of the Tax Penalty payable by the Company (Note 19).

The orders related to certain items of operating equipment and infrastructure and the Company's Mongolian bank accounts. The orders related to the operating equipment and infrastructure restricts the sale of these items; however, the orders do not restrict the use of these items in the Company's mining activities. The orders related to the Company's Mongolian bank accounts restricted the use of in-country funds but did not have any material impact on the Company's activities. The Restricted Funds were transferred to the CDIA as partial payment of the Tax Verdict in October and November 2015 (Note 19).

Following a review by the Company and its advisers, it is the Company's view that the orders placing restrictions on certain of the Company's Mongolian assets did not result in an event of default as defined under the terms of the CIC Convertible Debenture. However, the enforcement of the orders could ultimately result in an event of default of the Company's CIC Convertible Debenture, which if remains uncured for ten business days, would result in the principal amount owing and all accrued and unpaid interest will become immediately due and payable upon notice to the Company by CIC.

32. Contingencies continued

32.3 Class Action Lawsuit

In January, 2014, Siskinds LLP, a Canadian law firm, filed a class action (the "Class Action") against the Company, certain of its former senior officers and directors, and its former auditors, Deloitte LLP, in the Ontario Superior Court of Justice (the "Ontario Court") in relation to the Company's restatement of consolidated financial statements as previously disclosed in the Company's public filings.

To commence and proceed with the Class Action, the plaintiff was required to bring a preliminary leave motion and to certify the Class Action as a class proceeding (the "Leave Motion"). The Ontario Court rendered its decision on the Leave Motion on November 5, 2015.

The Ontario Court dismissed the plaintiff's Leave Motion as against each of the former senior officers and directors of the Company named in the Class Action on the basis that the "large volume of compelling evidence" proved the defense of reasonable investigation on the balance of probabilities and provided the basis for dismissing the Leave Motion as against them.

However, the Ontario Court allowed the Ontario class action to proceed under Part XXIII.1 of the Ontario Securities Act, permitting the plaintiff to commence and proceed with an action against the Company in respect of alleged misrepresentations affecting trades in the secondary market for the Company's securities arising from the restatement. The Company initiated the Corporation's Appeal to appeal this portion of the decision of the Ontario Court.

On his part, the plaintiff initiated the Individual's Appeal whereby the plaintiff appealed that part of the November 5, 2015 Ontario Court decision dismissing the action against former officers and directors of the Company. The Individual's Appeal was brought as of right to the Ontario Court of Appeal.

By Order dated September 12, 2016, the Corporation Appeal was transferred to the Ontario Court of Appeal to be heard together with the Individuals' Appeal. The Corporation Appeal was perfected on October 25, 2016 in the Ontario Court of Appeal.

Both the Individuals' Appeal and the Corporation Appeal will now be verbally argued together. The appeals are scheduled to be heard by the Ontario Court of Appeal in June 2017.

The Company disputes and is vigorously defending itself against the plaintiff's claims through independent Canadian litigation counsel retained by the Company and the other defendants for this purpose. Due to the inherent uncertainties of litigation, it is not possible to predict the final outcome of the Class Action or determine the amount of potential losses, if any. However, the Company has judged a provision for this matter at December 31, 2016 is not required.

32.4 Toll Wash Plant Agreement with Ejin Jinda

In 2011, the Company entered into an agreement with Ejin Jinda, a subsidiary of China Mongolia Coal Co. Ltd. to toll-wash coals from the Ovoot Tolgoi Mine. The agreement has a duration of five years from commencement of the contract and provided for an annual wet washing capacity of approximately 3.5 million tonnes of input coal.

Under the original agreement with Ejin Jinda, which required the commercial operation of the wet washing facility to commence on October 1, 2011, the additional fees payable by the Company under the wet washing contract would have been $18,500. At each reporting date, the Company assesses the agreement with Ejin Jinda and has determined it is not probable that these $18,500 will be required to be paid. Accordingly, the Company has determined a provision for this matter at December 31 2016 is not required.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

32. Contingencies continued

32.5 Mining Prohibition in Specified Areas Law

In July 2009, Mongolia promulgated the Law on Prohibiting Mineral Exploration and Extraction Near Water Sources, Protected Areas and Forests (the "Mining Prohibition in Specified Areas Law"). Pursuant to the Mining Prohibition in Specified Areas Law, the Government of Mongolia has defined the boundaries of certain areas in which exploration and mining is purportedly prohibited. A list of licenses has been prepared that overlap with the prohibited areas described in the law based on information submitted by water authority agencies, forest authority agencies and local authorities for submission to the Government of Mongolia.

In order to address the issues facing its implementation, in February, 2015 the Parliament of Mongolia adopted an amendment to the Law on Implementation of the Mining Prohibition in Specified Areas Law (the "Amended Law on Implementation"). The Amended Law on Implementation provides an opportunity for license holders covered within the scope of application of the Mining Prohibition in Specified Areas Law to continue their mining operations subject to advance placement of funds to cover 100% of the future environmental rehabilitation costs. A model contract and a specific Government regulation on this requirement will be adopted by the Government. The license holders must also apply within 3 months after the amendment to the Law on Implementation comes into effect for permission to MRAM to resume activities. The Company considered the development projects may be affected, but not the operating mines. The Company submitted its application with respect to its mining licenses before the deadline set on June 16, 2015 but has not yet received any communication from MRAM on the status of its application.

Pursuant to the Mongolian Law "To prohibit mineral exploration and mining operations at headwaters of rivers, water protection zones and forested areas", the government administrative agency has notified the Company that special license area 12726A is partly overlapping with a water reservoir. The Company has inspected the area together with the Cadastral Division of the Mineral Resource Authority as well as through the cadastral registration system of the Ministry of Environment, it is determined that 29 hectares of Sukhait Bulag is partly overlapping with a water reservoir, of which has been partly handed over. (Resolution No.6/7522 issued on September 29, 2015 by the Head of Cadastral Division of the Mineral Resource Authority)

In accordance with Article 22.3 of Law of Mongolia on Water, 5,602.96 hectares of land, including Sukhaityn Bulag, Uvur Zadgai, and Zuun Shand pertaining to exploration license 9443X, which was converted to mining license MV-0125436 in January 2016, is overlapping with protected area boundary. It has been officially handed over to the local administration. (Resolution No.688 issued on September 24, 2015 by the Head of Cadastral Division of the Mineral Resource Authority) In connection with the nullification of Annex 2 of the government order No.194 "On determining boundary" issued on June 5, 2012, area around the water reservoir located at MV-016869 license area and Soumber exploration license 9449X, which was converted to mining license MV-020451 in January 2016, has been annulled from the Specified Area Law.

Therefore, mining license 12726A and MV-016869 and exploration licenses 9443X, 9449X were removed from the list of licenses that overlaps with the prohibited areas described in the law.

There has been limited development of the law during 2016 while two exploration licenses of the Company (13779X and 5267X) were converted to mining licenses (MV-020676 and MV-020675) in November 2016. The Company will continue to monitor the developments and ensure that it follows the necessary steps in the Amended Law on Implementation to secure its operations and licenses and is fully compliant with Mongolian law.

32. Contingencies continued

32.6 Special Needs Territory in Umnugobi

On February 13, 2015, the entire Soumber mining license and a portion of SGS' exploration license No.9443X (9443X was converted to mining license MV-025436 in January 2016) (the "License Areas") were included into a special protected area (to be further referred as Special Needs Territory "SNT") newly set up by the Umnugobi Aimag's Civil Representatives Khural (the "CRKh") to establish a strict regime on the protection of natural environment and prohibit mining activities in the territory of the SNT.

On July 8, 2015, SGS and the Chairman of the CRKh, in his capacity as the respondent's representative, reached an agreement (the "Amicable Resolution Agreement") to exclude the License Areas from the territory of the SNT in full, subject to confirmation of the Amicable Resolution Agreement by the session of the CRKh. The parties formally submitted the Amicable Resolution Agreement to the appointed judge of the Administrative Court for her approval and requested a dismissal of the case in accordance with the Law of Mongolia on Administrative Court Procedure. On July 10, 2015, the judge issued her order approving the Amicable Resolution Agreement and dismissing the case, while reaffirming the obligation of CRKh to take necessary actions at its next session to exclude the License Areas from the SNT and register the new map of the SNT with the relevant authorities. Mining activities at the Soumber property cannot proceed until the License Areas are removed from the SNT.

On June 29, 2016, the Mongolian Parliament and CRKh election was held. As a result, the Company is aware that additional action may be taken in respect of the SNT; however, the Company has not yet received any indication on the timing of the next session of the CRKh.

32.7 Commercial Arbitration in Hong Kong

On June 24, 2015, First Concept served a notice of arbitration (the "Notice") on SGS in respect of a coal supply agreement dated May 19, 2014 as amended on June 27, 2014 (the "Coal Supply Agreement") for a total consideration of $11,500. The arbitral proceedings (the "Arbitration") are deemed to have commenced on June 24, 2015, as the date when the respondent received the Notice.

The Company firmly rejects the allegations of First Concept in the Notice as lacking any merit. The Arbitration was held in the fourth quarter of 2016 and the decision and related awards are not expected until the second quarter of 2017.

There can be no assurance, however, that the Company will prevail in the Arbitration. Should SGS be unsuccessful in the Arbitration, the Company may not be able to re-pay the sum of $11,500. In such case, this may result in an event of default under the CIC Convertible Debenture and CIC would have the right to declare the full principal and accrued interest owing thereunder immediately due and payable. Such an event of default under the CIC Convertible Debenture or the Company's inability to re-pay the sum of $11,500 to First Concept could result in voluntary or involuntary proceedings involving the Company (including bankruptcy).

32. Contingencies continued

32.8 Tax legislation

Mongolian tax, currency and customs legislation is subject to varying interpretations, and changes, which can occur frequently. Management's interpretation of such legislation as applied to the transactions and activity of the Company may be challenged by the relevant authorities. The Mongolian tax authorities may be taking a more assertive position in their interpretation of the legislation and assessments, and it is possible that transactions and activities that have not been challenged in the past may be challenged by tax authorities. As a result, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for five calendar years preceding the year of review. Under certain circumstances reviews may cover longer periods. The Mongolian tax legislation does not provide definitive guidance in certain areas, specifically in areas such as VAT, withholding tax, corporate income tax, personal income tax, transfer pricing and other areas. From time to time, the Company adopts interpretations of such uncertain areas that reduce the overall tax rate of the Company. As noted above, such tax positions may come under heightened scrutiny as a result of recent developments in administrative and court practices. The impact of any challenge by the tax authorities cannot be reliably estimated; however, it may be significant to the financial position and/or the overall operations of the entity.

Management believes that its interpretation of the relevant legislation is appropriate and the Company's positions related to tax and other legislation will be sustained. Management believes that tax and legal risks are remote at present. The management performs regular re-assessment of tax risk and its position may change in the future as a result of the change in conditions that cannot be anticipated with sufficient certainty at present. As of December 31, 2016, management has assessed that recognition of a provision for uncertain tax position is not necessary.

APPENDIX TO THE CONSOLIDATED FINANCIAL STATEMENTS

(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. Director and employee emoluments

Directors' emoluments

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

	Year ended December 31, 2016	2015
Directors' fees	$ **233**	$ 377
Other emoluments for executive and non-executive directors		
Salaries and other benefits	**905**	207
Share-based compensation	**66**	78
Directors' emoluments	$ **1,204**	$ 662

Year ended December 31, 2016 Name of director	Directors' fees	Salaries and other benefits	Share-based compensation	Total
Executive directors				
Ningqiao Li	$ **4**	$ **285**	$ **–**	$ **289**
Aminbuhe	**–**	**360**	**–**	**360**
Yulan Guo	**–**	**260**	**–**	**260**
	$ **4**	$ **905**	$ **–**	$ **909**
Non-executive directors				
Zhu Liu	$ **50**	$ **–**	$ **14**	$ **64**
Jin Lan Quan	**38**	**–**	**14**	**52**
Mao Sun	**72**	**–**	**19**	**91**
Pierre Lebel (i)	**36**	**–**	**–**	**36**
Huiyi Wang (ii)	**11**	**–**	**–**	**11**
Joseph Belan (ii)	**22**	**–**	**19**	**41**
	$ **229**	$ **–**	$ **66**	$ **295**
Directors' emoluments	$ **233**	$ **905**	$ **66**	$ **1,204**

(i) Resigned from the Board of Directors during the year ended December 31, 2016.

(ii) Appointed to the Board of Directors during the year ended December 31, 2016.

APPENDIX TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

A1. Director and employee emoluments continued

Directors' emoluments continued

Year ended December 31, 2015 Name of director	Directors' fees	Salaries and other benefits	Share-based compensation	Total
Executive directors				
Ningqiao Li (i)	$ 23	$ –	$ 13	$ 36
Aminbuhe (i)	3	110	13	126
Yulan Guo (i)	6	97	13	116
	$ 32	$ 207	$ 39	$ 278
Non-executive directors				
Zhu Liu (i)	$ 12	$ –	$ 13	$ 25
Jin Lan Quan (i)	10	–	13	23
Mao Sun (i)	8	–	13	21
Pierre Lebel	87	–	–	87
Huiyi Wang (ii)	–	–	–	–
Ted Chan (i) (iii)	35	–	–	35
W. Gordon Lancaster (iii)	91	–	–	91
André Deepwell (iii)	53	–	–	53
Kelly Sanders (iii)	30	–	–	30
Bold Baatar (iii)	10	–	–	10
Jeffery Tygesen (iii)	9	–	–	9
	$ 345	$ –	$ 39	$ 384
Directors' emoluments	$ 377	$ 207	$ 78	$ 662

(i) Appointed to the Board of Directors during the year ended December 31, 2015.

(ii) Appointed to the Board of Directors on February 18, 2016.

(iii) Resigned from the Board of Directors during the year ended December 31, 2015.

Five highest paid individuals

The five highest paid individuals included three directors of the Company for the years ended December 31, 2016 (2015: one director). The emoluments of the five highest paid individuals are as follows:

	Year ended December 31, 2016	2015
Salaries and other benefits	**$ 1,241**	$ 1,119
Share-based compensation	**–**	88
Compensation for loss of office	**–**	135
Total emoluments	**$ 1,241**	$ 1,342

APPENDIX TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

A1. Director and employee emoluments continued

The emoluments for the five highest paid individuals were within the following bands:

	Year ended December 31, 2016	2015
HK$1,000,001 to HK$1,500,000	**1**	2
HK$1,500,001 to HK$2,000,000	**1**	2
HK$2,000,001 to HK$2,500,000	**2**	–
HK$2,500,001 to HK$3,000,000	**1**	–
HK$4,500,001 to HK$5,000,000	**–**	1
	5	5

A2. Five year summary

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

	Year ended December 31, 2016	2015	2014	2013	2012
Revenue	**$ 58,450**	$ 16,030	$ 24,494	$ 58,636	$ 78,061
Gross loss	**(28,595)**	(47,661)	(57,638)	(53,991)	(49,346)
Net comprehensive loss attributable to equity holders of the Company	**$ (64,729)**	$ (188,040)	$ (104,197)	$ (236,950)	$ (114,061)
Basic loss per share from continuing and discontinued operations	**$ (0.24)**	$ (0.79)	$ (0.55)	$ (1.30)	$ (0.54)
Diluted loss per share from continuing and discontinued operations	**$ (0.24)**	$ (0.79)	$ (0.55)	$ (1.30)	$ (0.60)

	As at December 31, 2016	2015	2014	2013	2012
Total assets	**$ 259,321**	$ 290,474	$ 416,139	$ 506,206	$ 732,452
Less: total liabilities	**(213,308)**	(179,781)	(131,858)	(131,149)	(128,469)
Total net assets	**$ 46,013**	$ 110,693	$ 284,281	$ 375,057	$ 603,983

A3. Cash

The Company's cash is denominated in the following currencies:

	As at December 31, 2016	2015
Denominated in U.S. Dollars	**$ 269**	$ 21
Denominated in Chinese Renminbi	**296**	94
Denominated in Mongolian Tugriks	**287**	182
Denominated in Canadian Dollars	**85**	20
Denominated in Hong Kong Dollars	**29**	60
Cash	**$ 966**	$ 377

CORPORATE INFORMATION

Directors

Executive Directors:

Mr. Ningqiao Li (Executive Chairman)
Mr. Aminbuhe
Mr. Yulan Guo

Non-Executive Director:

Mr. Huiyi Wang

Independent Non-Executive Directors:

Mr. Mao Sun (Interim Lead Director)
Mr. Joseph Belan
Mr. Zhu Liu
Ms. Jin Lan Quan

Audit Committee

Mr. Mao Sun (Chair)
Mr. Joseph Belan
Mr. Zhu Liu
Ms. Jin Lan Quan

Nominating and Corporate Governance Committee

Mr. Joseph Belan (Chair)
Mr. Zhu Liu
Ms. Jin Lan Quan
Mr. Mao Sun

Compensation and Benefits Committee

Mr. Zhu Liu (Chair)
Mr. Joseph Belan
Ms. Jin Lan Quan
Mr. Mao Sun

Health, Environment, Safety and Social Responsibility Committee

Mr. Aminbuhe (Chair)
Mr. Yulan Guo
Mr. Zhu Liu

Company Secretary

Ms. Allison Snetsinger

Hong Kong Company Secretary

Mr. Siu Man Kwok

Registered Office

Suite 1100 – 355 Burrard Street, Vancouver, British Columbia Canada V6C 2G8

Principal Place of Business in Hong Kong

Suite 3712 – 15, Tower Two, Times Square, 1 Matheson Street, Causeway Bay, Hong Kong

Principal Place of Business in Mongolia

8th Floor, Monnis Building, Orgil Stadium 22, Great Mongolian State Street, 15th Khoroo, Khan-Uul District, Ulaanbaatar, Mongolia, 17011

Principal Bankers

Canada:

BMO Bank of Montreal

Hong Kong:

Standard Chartered Bank (Hong Kong) Limited

Principal Share Registrar

CST Trust Company
Suite 1600 – 1066 West Hastings Street, Vancouver, British Columbia Canada V6E 3X1

Branch Share Registrar

Computershare Hong Kong Investor Services Limited
Shops 1712 – 1716, 17/F, Hopewell Centre,
183 Queen's Road East, Wan Chai, Hong Kong

Independent Auditor

PricewaterhouseCoopers LLP

Website address

www.southgobi.com