

## **ALAMOS GOLD INC.**

### **MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(All amounts are expressed in United States dollars, unless otherwise stated.)**

This management's discussion and analysis ("MD&A") of the operating results and financial position of Alamos Gold Inc. and its subsidiaries (the "Company") is for the year ended December 31, 2005 compared with the year ended December 31, 2004. Together with the audited consolidated financial statements and related notes, the MD&A provides a detailed account and analysis of the Company's financial and operating performance for the year. The Company's measurement currency and reporting currency is the United States dollar. This MD&A is current to March 15, 2006 and should be read in conjunction with the Company's Annual Information Form and other corporate filings available at [www.sedar.com](http://www.sedar.com) (SEDAR). Management is responsible for the consolidated financial statements referred to in this MD&A, and provides officers disclosure certifications filed with securities commissions on SEDAR. The audit committee reviews the 2005 audited consolidated financial statements and MD&A, and recommends approval to the board of directors.

#### **Note to U.S. Investors**

All references to mineral reserves and resources contained in this MD&A are determined in accordance with National Instrument 43-101, Standards of Disclosure for Mineral Projects ("NI 43-101") of the Canadian Securities Administrators ("CSA") and Canadian Institute of Mining, Metallurgy and Petroleum ("CIM") standards. While the terms "mineral resource," "measured mineral resource," "indicated mineral resource," and "inferred mineral resource" are recognized and required by Canadian regulations, they are not defined terms under the Securities and Exchange Commission ("SEC") standards in the United States ("U.S."). As such, information contained in this MD&A concerning descriptions of mineralization and resources under Canadian standards may not be comparable to similar information made public by U.S. companies subject to the reporting and disclosure requirements of the SEC. "Indicated mineral resource" and "inferred mineral resource" have a great amount of uncertainty as to their existence and economic and legal feasibility. It cannot be assumed that all or any part of an "indicated mineral resource" or "inferred mineral resource" will ever be upgraded to a higher category of resource. Investors are cautioned not to assume that all or any part of the mineral deposits in these categories will ever be converted into proven and probable reserves.

#### **Overview:**

Alamos Gold Inc. is a publicly traded company on the Toronto Stock Exchange (TSX: AGI) formed through the amalgamation of National Gold Corporation and Alamos Minerals Limited on February 21, 2003. The Company owns 100% of the 21,300-hectare Salamandra group of concessions located in the state of Sonora in northwest Mexico. The Salamandra group of concessions includes the Mulatos deposit and more than nine other prospective exploration targets. The Company commenced mining its Mulatos deposit from the Estrella Pit in 2005.

The Company has four elements to its business strategy:

- Establish itself as a gold producer with improving operating performance and expanding production profile;
- Increase proven and probable reserves through conversion of measured and indicated resources;

- Make a new mineral discovery on its extensive concessions at Salamandra and expand resources;
- Add resources and proven and probable reserves through the acquisition of prospective mineral properties.

During 2005, the Company made significant progress on the first three components of its business strategy. Advances on its fourth strategy are more dependent on factors outside the Company's control, such as the availability of mineral properties at a reasonable price which meet the Company's investment criteria.

The Company was successful in completing construction of the Mulatos mine (the "Mine") in 2005. The first bar of gold dore was poured from the Mine in July and construction was substantially complete by December 2005, with the exception of the crusher and conveying system which became operational in early 2006. The Mine reached feasibility processing levels in February 2006, and the Company forecasts gold production of between 140,000 and 155,000 ounces of gold in 2006.

Initial ore production from the Mine is derived from the Estrella Pit, which contains proven and probable reserves of 36.4 million tonnes grading 1.64 grams per tonne of gold (g/t) or approximately 1.9 million contained ounces of gold. Current proven and probable reserves are contained within a measured and indicated resource of 62.2 million tonnes grading 1.51 g/t, or approximately 3 million contained ounces of gold.

The Company is also actively exploring and developing other targets within the Salamandra concessions. Development drilling was undertaken at El Salto and Mina Vieja adjacent to the Estrella deposit, and is in progress at Escondida and El Victor north of Estrella with the objective of increasing existing resources and upgrading measured and indicated resources to proven and probable reserves. In December 2005, the Company announced a high-grade discovery at Escondida. Exploration drilling is underway at the El Jaspe, Los Bajios and El Realito targets. At this time, the Company is awaiting a revision to its proven and probable reserves at Estrella incorporating results from El Salto and Mina Vieja.

### **2005 Highlights:**

During the year, the Company:

- Closed a CDN\$50 million convertible debenture issue in February 2005, the proceeds of which were used to fund construction of the Mine;
- Secured a \$10 million revolving credit facility, which was increased to \$16 million subsequent to year end;
- Poured its first bar of gold dore from the Mine in July 2005;
- Substantially completed construction of the Mine in the fourth quarter of 2005 at a total cost of approximately \$74 million, compared to the feasibility study budget of \$73.4 million;
- Commenced a \$20 million expansion program to increase throughput by 50% above the feasibility level to 15,000 tonnes of ore per day;
- Produced 7,647 ounces of gold in dore and sold 5,950 ounces of refined gold for proceeds of \$2.7 million at a cash operating cost of \$382 per ounce;
- Invested \$4.7 million in exploration activities resulting in the discovery of the new high grade Escondida Hanging Wall Zone, located 500 meters northeast of the Estrella Pit, and a 55% increase in resources in the El Salto/Mina Vieja areas;

- Entered into a letter agreement to dispose of its non-core La Fortuna property for proceeds estimated at \$2.0 million;
- Incurred a loss of \$9.4 million (\$0.12 per share).

### Selected Annual Information:

(000s)	2005	2004	2003
	\$	(restated) \$	\$
Operating revenues	2,726	-	-
Loss	9,447	4,767	1,934
Total assets	126,200	74,884	28,423
Total long-term financial liabilities	39,042	50	-
Loss per share	\$0.12	\$0.08	\$0.05
Cash dividends	-	-	-

The Company commenced construction of its Mine in 2004 and began production in 2005. Construction was funded, in part, through a CDN\$50 million convertible debenture issue and \$4.8 million in capital leases. Losses have increased due to the adoption of accounting policies relating to the expensing of stock-based compensation commencing in 2004, and financing-related costs commencing in 2005. No dividends were declared in the reported periods.

### Results of Operations:

The Company's major asset is the Salamandra group of concessions in Sonora, Mexico which totals approximately 21,300 hectares and includes the Mulatos deposit and more than nine other exploration targets identified to date. The Mulatos deposit consists of several contiguous mineralized zones which contain gold resources of approximately 62.2 million tonnes of ore grading 1.51 g/t at a 0.6 g/t gold cut-off, measured and indicated, excluding mineralization contained in the Gap, El Victor and San Carlos zones. In June 2004, a feasibility study was completed on the Estrella zone of the Mulatos deposit, which contained gold proven and probable reserves of 36.4 million tonnes of ore grading 1.64 g/t at varying cut-off grades, beginning with 0.8 g/t in the early years and declining to the internal cut-off in later years to enhance economics. Proven and probable reserves are 1.9 million ounces of contained gold, of which 1.4 million ounces are recoverable, based on metallurgical testing. Proven and probable reserves were calculated using a gold price assumption of \$350 per ounce. During 2005, 829,509 tonnes of ore were mined at an average grade of 1.52 grams per tonne of ore.

Construction of the Mine on the Mulatos deposit began in the third quarter of 2004 and operations commenced in the third quarter of 2005 with the pouring of the first dore bar of gold and silver weighing 117 ounces. Dore is sent to a third party refinery for final processing into saleable metals. Construction was substantially completed in the fourth quarter of 2005, with uncrushed run-of-mine ore and colluvial material being stockpiled and stacked on the leach pads in the third and fourth quarters of 2005. Commissioning of the crusher and conveying system was successfully completed in early 2006. Gold production at the Mine in the fourth quarter of 2005 was 5,517 ounces of gold in dore, of which 4,950

ounces of gold were refined and sold. For the full year, the Mine produced 7,647 ounces of gold (subject to final refinery settlements), and 5,950 ounces were sold.

The tables below outline key production and cost indicators during the fourth quarter of 2005 and year to date compared with feasibility study rates and costs:

<b>Production summary</b>	<b>Q4 2005</b>	<b>YTD 2005 (1)</b>	<b>Feasibility Study (2)</b>
Ounces produced	5,517	7,647	N/A
Ore mined – tonnes	634,398	829,509	519,000
Waste mined – tonnes	2,207,501	3,262,553	2,482,000
Total tonnes mined	2,841,899	4,092,062	3,001,000
Waste-to-ore ratio	3.48	3.93	4.78
Grade (g/t)	1.57	1.52	1.67

<b>Costs per tonne summary</b>	<b>Q4 2005</b>	<b>YTD 2005 (1)</b>	<b>Feasibility Study (3)</b>
Mining cost per tonne	\$1.56	\$1.45	\$1.11
Mining cost per tonne of ore	\$7.00	\$7.15	\$6.40
Crushing cost per tonne of ore	N/A	N/A	N/A
Processing cost per tonne of ore	\$2.31	\$2.00	\$1.98
Administration cost per tonne of ore	\$0.99	\$0.95	\$0.97
<b>Cost per tonne of ore</b>	<b>\$10.30</b>	<b>\$10.10</b>	<b>\$9.35</b>

(1) YTD 2005 is from July 1 to December 31, coincident with production from the Mine.

(2) Reflects mine production indicators during the start-up period as reported in the feasibility study.

(3) Mining cost per tonne and mining cost per tonne of ore reflect mining costs during the start-up period as reported in the feasibility study. Crushing cost per tonne of ore is not applicable as the feasibility study contemplated stockpiling of ore during the start-up phase. Processing cost per tonne of ore and administration cost per tonne of ore presented in the table above reflect average life of mine amounts.

The Mine was in a pre-commercial start-up phase during 2005. Revenue from gold sales and related operating costs were recognized commencing with the Mine's first gold pour in July 2005. However, the Mine had not reached commercial production, and the crushing and conveying circuit was not fully commissioned and operational until 2006.

In the table above, feasibility study mining costs per tonne and mining costs per tonne of ore represent the costs indicated in the feasibility study for the start-up period. The feasibility study contemplated the stockpiling of ore during the start-up phase, whereas the Mine delivered run-of-mine ore directly to the leach pad during this period. Crushing costs per tonne of ore are not presented as the crusher was not operational in 2005. Processing and administration costs per tonne of ore presented in the table above reflect the average life of mine feasibility level costs.

Year-to-date mining costs per tonne of ore were higher than feasibility study levels due to the following factors:

- The average life of mine waste-to-ore ratio as indicated in the feasibility study is 1.4:1 with mining costs at \$0.95 per tonne. The mine plan during the start-up period had a waste-to-ore ratio of 3.93:1 for the first 4.1 million tonnes of ore and waste mined at a mining cost of \$1.45 per tonne. Mining cost per tonne was higher than the average life of mine feasibility levels due to a significantly higher actual waste-to-ore ratio, and was higher than feasibility study levels during the start-up period due to increased haul distances and costs, as described below.
- The haulage distance for ore to the leach pad was approximately 4.5 kilometers as compared to the feasibility study haul distance from the pit to the crusher site of approximately 1 kilometer.
- Higher than forecast expenditures on material and consumables, primarily diesel fuel, also added to operating costs as all materials and personnel are trucked to the Mine's remote site, and diesel fuel is the primary energy source for the Mine.

Cash operating cost per ounce of gold sold was \$382 in 2005. Cash operating costs were higher than feasibility due to the higher mine costs noted above and due to expected lower recoveries from run-of-mine ore compared with crushed ore.

The Company believes that investors use certain indicators to assess gold mining companies. They are intended to provide additional information and should not be considered in isolation or as a substitute for measures of performance prepared with GAAP. **"Mining cost per tonne of ore"** is a non-GAAP performance measurement which could provide an indication of the mining and processing efficiency and effectiveness at the Mine. It is determined by dividing the relevant mining and processing costs by the tonnes of ore processed in the period. **"Cost per tonne"** is usually affected by operating efficiencies and waste-to-ore ratios in the period. **"Cash operating cost per ounce"** and **"total cash cost per ounce"** as used in this analysis are non-GAAP terms typically used by gold mining companies to assess the level of gross margin available to the Company by subtracting these costs from the unit price realized during the period. These non-GAAP terms are also used to assess the ability of a mining company to generate cash flow from operations. There may be some variation in the method of computation of **"cash operating cost per ounce"** as determined by the Company compared with other mining companies. In this context, **"cash operating cost per ounce"** reflects the cash operating cost allocated from in-process and dore inventory associated with ounces of gold sold in the period. **"Cash operating cost per ounce"** may vary from one period to another due to operating efficiencies, waste-to-ore ratios, grade of ore processed and gold recovery rate in the period. **"Total cash cost per ounce"** includes **"cash operating cost per ounce"** plus applicable cash royalties.

Production from the Mine is subject to a sliding scale net smelter royalty commencing on commercial production as defined in the relevant royalty agreement, which at current gold prices above \$400 is set at a rate of 5% of the value of gold and silver, less certain allowed refining and transportation costs. No royalties are expected to be payable on 2005 gold production.

In the fourth quarter of 2005, production was 5,517 ounces of gold. During this quarter, the Company was able to mine ore and waste at a rate higher than initially planned, however, expected lower recoveries from run-of-mine ore (as opposed to ore crushed to feasibility study specifications) resulted in lower production. Block model reconciliations for full

benches in the fourth quarter and early in 2006 at Estrella show close correlation to the reserve block model, exhibiting slightly higher overall gold content within ore-grade blocks.

The Company has not yet commenced commercial production and is focused on attaining this milestone. To achieve optimal performance the Company expects to reduce the cash cost per tonne of ore experienced in the pre-commercial phase to the feasibility level of \$6.54 by using a higher throughput to achieve economies of scale and to offset higher expected energy costs. In addition, the Company expects that optimal crushing will increase recoveries experienced in the pre-commercial run-of-mine phase and lower the operating cash cost per ounce to the \$210-\$225 range, after initially producing dore from existing higher cost in-process inventories.

The Company intends to actively develop the Escondida Hanging Wall deposit and develop the lower-grade main zone through its underground drill program. This should allow the Company to maintain its initial 10-year mine life, while at the same time forecasting production at levels significantly higher than the feasibility average of 140,000 ounces gold per year.

### **Financial Highlights:**

Prior to July 1, 2005, the Company was a development stage mineral exploration Company focused on developing and constructing the mine at the Mulatos Project. Accordingly, comparative quarterly and annual financial results do not reflect the results of mining activities.

The Company's financial results for the quarter and year ending December 31, 2005 are presented below:

	<b>Q4 2005</b>	<b>YTD 2005</b>	<b>Q4 2004 (restated)</b>	<b>YTD 2004 (restated)</b>
Cash flow from operations (before working capital change) (000)	(\$1,801)	(\$5,105)	(\$1,534)	(\$3,568)
Loss for the period (000)	\$3,145	\$9,447	\$2,076	\$4,767
Loss per share	\$0.04	\$0.12	\$0.03	\$0.08
Weighted average number of common shares outstanding	77,384,164	77,179,619	73,074,061	62,202,713

Increased costs in 2005 on a quarterly and year-to-date basis are primarily the result of interest, accretion and foreign exchange losses associated with the Company's issuance of a CDN\$50 million convertible debenture in February 2005. For the year ended December 31, 2005, these costs represent an increase of \$4.9 million over the comparable period in 2004.

In addition, exploration costs charged to operations during the year of \$1.9 million were \$0.9 million higher than the same period in 2004.

### **Gold sales**

Details of gold sales for the three-month and six-month periods ended December 31, 2005 are presented below (1):

	Q4 2005	YTD 2005 (1)
Gold sales – ounces	4,950	5,950
Gold sales revenues	\$2,285,478	\$2,726,391
Realized gold price per ounce	\$462	\$458
Average gold price for period (London PM Fix) (1)	\$484	\$462

(1) YTD 2005 is from July 1 to December 31, coincident with production from the Mine

### **Assessment of Gold Market**

The gold price fluctuated significantly during the fourth quarter reaching a quarterly low of \$456.50 per ounce in early November and a yearly high of \$536.50 on December 12, 2005. The price of gold started the year trading in the \$420 per ounce range and ended the year trading above \$500 per ounce for the majority of December.

At March 15, 2006 the gold price had increased from its December high of \$536.50 per ounce to \$556.50 per ounce. The increased gold price is beneficial to the Company, which prepared its feasibility study and proven and probable reserves using a base case of \$350 per ounce. At recent levels, the price of gold has had and may continue to have a positive impact on the economics of the feasibility study for Phase I development of the Mulatos deposit. However, it is not possible to forecast future gold price trends and their impact on future results from operations.

### **Operating Expenses**

Mine operating costs allocated to ounces sold are summarized in the table below:

	Q4 2005	YTD 2005 (1)
Gold production – ounces	5,517	7,647
Gold sales – ounces	4,950	5,950
Mining and processing (\$)	1,970,234	2,269,927
<b>Cash operating costs (\$)*</b>	<b>1,970,234</b>	<b>2,269,927</b>
<b>- Per ounce sold</b>	<b>\$398</b>	<b>\$382</b>
Royalties and production taxes (\$)	-	-
<b>Total cash costs (\$)***</b>	<b>1,970,234</b>	<b>2,269,927</b>
<b>- Per ounce sold</b>	<b>\$398</b>	<b>\$382</b>
Amortization (\$)	476,904	560,967
Accretion of asset retirement obligation (\$)	7,000	11,000
<b>Total production costs (\$)***</b>	<b>2,454,138</b>	<b>2,841,894</b>
<b>- Per ounce sold</b>	<b>\$496</b>	<b>\$478</b>

\* Includes all direct mining costs, refining and transportation costs and by-product credits.

\*\*Includes all cash operating costs and royalties and production taxes.

\*\*\*Includes all total cash costs, amortization, and accretion of asset retirement obligations.

(1) Note: Reflects amortization and accretion of asset retirement obligation costs for the period subsequent to June 30, 2005 only.

Exploration costs charged to operations during the year totaled \$1,889,060 compared to \$994,591 in 2004. During the year, the Company changed its accounting policy for exploration costs. In the past, as the Company was in the development stage, exploration costs were capitalized. Under the new accounting policy, certain exploration costs are expensed if the costs do not meet the criteria for classification as mine development costs. During the year, the Company invested a total of \$4,650,091 in exploration activities compared to \$1,479,905 in 2004.

Corporate and administrative expenses of \$577,876 in the fourth quarter of 2005 were 28% lower than the \$797,487 incurred in the comparable period of 2004. The key components of this expense are shown below:

	<b>Q4 2005</b>	<b>YTD 2005</b>	<b>Q4 2004</b>	<b>YTD 2004</b>
Salaries and management fees	198,177	1,316,724	159,023	859,310
Legal, audit and accounting	85,078	252,393	97,331	343,137
Office and administration	186,819	552,147	362,517	552,924
Shareholder communications	18,896	278,251	69,572	232,798
Travel and accommodation	86,662	276,062	64,990	230,942
Trust and filing fees	2,244	115,834	44,054	196,145
	<b>577,876</b>	<b>2,791,411</b>	<b>797,487</b>	<b>2,415,256</b>

Year-to-date corporate and administrative expenses in 2005 were 16% higher than in 2004. The increase in 2005 is primarily attributable to bonuses paid in the year ended December 31, 2005, being approximately \$0.2 million higher than in the same period of 2004. Bonus payments are classified within salaries and management fees.

Legal, audit and accounting costs and trust and filing fees decreased in 2005 as the corresponding amounts in 2004 included costs associated with the Company obtaining its Toronto Stock Exchange listing. These reductions in costs were partially offset by higher shareholder communications and travel and accommodation costs incurred in 2005. The Company expects corporate and administration costs to be approximately \$2.5 million in 2006.

The value of stock based compensation allocated to expense was \$1,142,000 in 2005 compared to \$943,965 in 2004.

	<b>2005</b>	<b>2004</b>
Number of stock options granted	1,945,000	1,725,000
Average exercise price of options granted (CDN\$)	\$4.57	\$2.55
Value of stock based compensation (as determined by Black Scholes option pricing model)	\$2,088,000	\$1,169,353
Allocated to stock based compensation expense	\$1,142,000	\$943,965
Allocated to mineral property, plant and equipment	\$151,000	\$225,388

Unamortized stock based compensation expense at December 31	\$795,000	\$-
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On June 3, 2005, 1,325,000 stock options were granted. The fair value associated with these stock options was estimated to be \$1,078,000 of which \$927,000 was expensed, and \$151,000 was capitalized to mineral property, plant and equipment, based on the nature of the grant. All of the June 3, 2005 options vested immediately on grant, resulting in the entire fair value being recognized in 2005. On December 23, 2005, 620,000 stock options were granted with an estimated value of \$1,010,000. Of the 620,000 options granted, 460,000 vest over a two-year period and 160,000 vest over a nine-month period. Accordingly, the fair value of \$1,010,000 is amortized to expense over the vesting period and \$795,000 of unamortized stock based compensation expense was outstanding at December 31, 2005.

The average exercise price of the 1,945,000 stock options granted in 2005 was CDN\$4.57 as compared to CDN\$2.55 for the 1,725,000 stock options granted in 2004. The higher exercise price and number of options granted in 2005 resulted in the value of stock based compensation being approximately 79% higher.

### ***Financial Revenues and Expenses***

#### **Interest income**

The Company earned \$856,044 in interest income in 2005 compared to \$234,219 in 2004. The higher interest income is the result of higher average cash balances maintained throughout 2005 resulting from the proceeds of the debenture offering in early February 2005.

#### **Interest expense**

Interest expense in 2005 of \$1,823,609 primarily represented interest on the CDN\$50 million, 5.5% convertible debentures issued in February 2005. The interest expense recorded for the year is net of \$253,750 of interest costs which directly related to financing construction of the Mine and were capitalized to mineral property, plant and equipment. During the same period of 2004, \$288,149 of interest expense was incurred related to a previous loan which was repaid in December 2004.

#### **Financing charges**

Financing charges for the year ended December 31, 2005 amounted to \$342,082 as compared to \$390,473 in the same period of 2004. In February 2005, the Company incurred financing charges of \$1,637,871 with respect to the convertible debenture issuance. Of this amount, \$416,000 was allocated to the equity component of the convertible debenture. The remaining costs of \$1,221,871 are amortized to expense over the five-year term of the debentures. Accordingly, \$223,200 of these costs were recognized in 2005. The other significant component of financing charges in 2005 relates to the revolving credit facility entered into in July 2005. The lender was issued 350,000 warrants exercisable until July 21, 2007 at a price of CDN\$5.80. The value of the warrants issued was estimated using the Black Scholes option pricing model at \$265,000. This financing charge is deferred and amortized on a straight-line basis over the initial one year term of the credit facility. In 2004, the costs incurred to establish a non-recourse bank facility were charged to operations when the facility was terminated.

### **Accretion of convertible debenture discount**

Accretion expense in 2005 amounted to \$1,272,125 (2004 - \$nil), net of capitalized accretion of \$178,980.

### **Foreign exchange gain (loss)**

The Company incurred a loss on foreign exchange of \$711,550 in 2005 primarily due to the strengthening of the Canadian dollar against the United States dollar throughout the year. The foreign exchange rate increased from \$1US = \$0.81CDN at February 2, 2005, the date the Company completed its convertible debenture issuance to \$1US = \$0.86CDN at December 30, 2005.

The Company's main foreign currency exposure results from the CDN\$50 million debenture liability due in February 2010. Most of the proceeds of the convertible debenture offering were converted into United States dollars to meet funding requirements for construction of the Mine. Consequently the Company has a large Canadian dollar monetary liability with a lesser amount of financial assets in the same currency. As a result, it is exposed to a financial gain or loss when there is a change in the exchange rate between the Canadian dollar and the United States dollar. Management has elected to hedge a portion of this exposure through the purchase of Canadian dollar forward contracts. A portion of the Canadian dollar debt was not hedged throughout 2005 as management anticipated the receipt of Canadian dollars on the exercise of its outstanding warrants with an exercise price of CDN\$3.50 scheduled to expire on April 8, 2006. The foreign exchange loss related to the debt portion of the convertible debentures in 2005 amounted to \$1.9 million as the Canadian dollar strengthened, increasing the U.S. dollar cost to the Company of settling this obligation. Offsetting the foreign exchange loss on the debenture is the realized foreign exchange gains on Canadian dollar denominated short-term investments and cash held by the Company during the year. In addition, the Company recognized approximately \$1.1 million in unrealized foreign exchange gains on fixed price contracts to purchase \$26 million Canadian dollars. In 2006 the Company expects its exposure to fluctuations in foreign exchange rates on account balances to be reduced as monetary assets are expected to be approximately the same as monetary liabilities in each of its non-reporting currencies.

### **Income Taxes**

The Company has not provided for income taxes on a current or future basis in 2005. However, it is anticipated that the Company will provide for future taxes based on planned income attributable to gold sales in Mexico in 2006. The 2006 statutory tax rates in Mexico and Canada are 29% and 36% respectively.

### **Summary of Quarterly Results**

The following table summarizes quarterly results for the past eight quarters. The Company began operations at the Mine in the third quarter of 2005. Accordingly, no gold sales revenue was reported for periods prior to the third quarter of 2005. Diluted per share amounts have not been presented as the effect on each quarterly loss would be anti-dilutive.

The quarterly amounts presented in the table below have been re-stated to reflect the new accounting policy the Company adopted in 2005 with respect to mineral exploration.

<b>2005 (restated)</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>	<b>YTD</b>
Gold production (ounces)	-	-	2,130	5,517	7,647
Gold sales (ounces)	-	-	1,000	4,950	5,950
Gold sales (\$000)	-	-	441	2,285	2,726
Loss from operations (\$000)	954	2,166	973	2,060	6,153
Loss for the period (\$000)	1,381	2,474	2,448	3,143	9,446
Basic and diluted loss per share (\$ per share)	0.02	0.03	0.03	0.04	0.12
Cash flow from operations (before changes in non-cash working capital)(\$000)	(264)	(1,581)	(1,459)	(1,801)	(5,105)

<b>2004 (restated)</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>	<b>YTD</b>
Loss for the year (\$000)	472	1,521	697	2,076	4,766
Basic and diluted loss per share (\$ per share)	0.01	0.03	0.01	0.03	0.08
Cash flow from operations (before changes in non-cash working capital)(\$000)	(406)	(1,070)	(558)	(1,534)	(3,568)

Significant variations in losses in each quarter include:

- Non-cash stock-based compensation expense of \$927,000 and \$215,000 in Q2 and Q4 2005 as compared to \$82,775, \$469,190 and \$392,000 in Q1, Q2 and Q4 respectively of 2004.
- Bonus compensation was granted in the amount of \$407,600 in Q2 2005 and \$215,000 in Q2 2004.

In addition, the quarterly financial results for Q1 through Q4 of 2005 contain charges for accretion, interest and financing charges relating to the convertible debenture issued in February 2005.

### **Financial and Other Instruments**

The Company's financial assets and liabilities consist of cash and cash equivalents, receivables, accounts payable and accrued liabilities and the liability portion of a convertible debenture, some of which are denominated in Canadian dollars or Mexican pesos. These accounts are recorded at cost, except for the convertible debenture, which approximates its accreted value at each reporting period in United States dollars. The convertible debenture was initially recorded at the discounted value of future cash flows, using the Company's risk adjusted discount rate of 12.6%, and is adjusted quarterly for changes in the Canadian dollar to United States dollar exchange rate. The debenture discount is accreted to the carrying value of the debenture on a quarterly basis. The Company is exposed to financial gain or loss as a result of foreign exchange movements against the United States dollar.

For the year ended December 31, 2005, the Company recorded a foreign exchange loss of \$711,550 compared to a foreign exchange gain in the same period of 2004 of \$121,668. The Company minimizes its foreign exchange risk by maintaining low net account balances in Canadian dollars and Mexican pesos, to the extent possible. The Company has entered into agreements to acquire \$26 million Canadian dollars at fixed future prices to offset a portion of its Canadian dollar debenture liability which is not offset by Canadian dollars on deposit. The Company has placed its cash and cash equivalents in short-term liquid deposits or investments which provide a revised rate of interest upon maturity.

The Company has limited exposure to monetary assets and liabilities denominated in Mexican pesos, but the Company does incur operating costs denominated in both the Canadian dollar and the Mexican peso. Accordingly, the Company's operating costs are affected by changes in foreign exchange rates in those currencies. The Company has elected not to hedge these exposures by buying fixed rate forward contracts in either the Mexican peso or the Canadian dollar as the exchange rate for both currencies has been stable in recent periods and the Company does not anticipate significant volatility in 2006.

At December 31, 2005, the Company had outstanding gold forward contracts to sell 2,000 ounces of gold in January 2006. These contracts were not designated as hedges at inception. The mark-to-market valuation of these contracts resulted in a loss of \$93,600. The Company contracts for future gold sales to closely match expected delivery dates within the current financial quarter. At this time, the Company does not anticipate entering into long-term forward sales contracts as the gold price currently appears to have some upward bias due to strong physical and investment demand. The Company will continually monitor the effectiveness of this policy.

### **Investment in Mineral Property, Plant and Equipment**

Cash invested in mineral property, plant and equipment for the year ended December 31, 2005 was approximately \$58 million. Construction of the Mine was substantially completed in December 2005 at a total cost of approximately \$74 million after the allocation of \$2.5 million of non-essential work to Phase II. This compared to the budgeted amount to complete the initial phase of \$73.4 million, although some projects, such as a permanent truck shop, were removed from the construction budget and allocated to future sustaining capital. The variance over the budgeted amount is primarily due to higher than budgeted costs associated with refurbishing and installing the crusher and conveying system. Phase I leach pad costs were also higher than budget. Mining capital and equipment costs were lower as a result of purchasing some used mining equipment. Allocations from contingency and cost escalation compensated for substantially all specific cost area over-runs.

During the year, the Company commenced a planned expansion of the Mine from a budgeted rate of 10,000 tonnes of ore per day to 15,000 tonnes of ore per day to more closely align production with the capacity at the crusher/conveyor and gold recovery plant. Approximately \$20 million was budgeted for this expansion, which included \$10.4 million for additional haulage equipment in 2005. The equipment was acquired in 2005 ahead of mining requirements in order to supplement the Company's existing mining equipment and to replace construction contractors' equipment which generally did not meet the performance and availability stipulated in the contracts. An additional \$10 million is planned to be spent in 2006 for loaders, dozers, graders and Mine infrastructure to support the Mine expansion. Included in the planned expansion for 2006 is \$1.9 million of capital for leach

pad expansion to accommodate the additional expansion tonnage. The crusher, conveyor and plant currently have sufficient capacity to handle the additional planned output.

Major cost areas and variances from the approved budget for the Mulatos Mine Project were:

**Mulatos Mine Project Costs**

(000s) Cost Area	Budget	Estimated Cost at Completion	Variance fav (unfav)
	\$	\$	\$
Mining Capital	12,587	10,480	2,107
Crushing	12,257	21,088	(8,831)
Leaching	7,985	10,675	(2,690)
Carbon Plant / ADR	2,721	4,173	(1,452)
Utilities and infrastructure	12,757	13,527	( 770)
Engineering, procurement and construction management	4,106	4,606	( 500)
Contingency, escalation and other	9,398	-	9,398
Owner's cost	11,680	9,689	1,991
Totals	73,491	74,238	( 747)

The Company recorded an increase of \$2,050,000 in the valuation of its asset retirement obligation in 2005. This increase in the valuation reflects the future liabilities incurred during the period based on completion of construction of the Mine. The valuation of the asset retirement obligation reflects the discounted cash flows anticipated for future removal and site restoration and is added to the cost of mineral property and mine development. Project closure costs include waste dump cover, heap leach closure, equipment decommissioning and removal. This is in addition to progressive reclamation of the waste dumps.

**Mineral property held for sale**

In November 2005, the Company entered into a letter agreement with Morgain Minerals Inc. ("Morgain") to sell the La Fortuna property for consideration of five million common shares of Morgain. The Company and Morgain also intend to enter into a Technical Services Contract for a 1% net smelter royalty ("NSR") on future production from the La Fortuna property. The La Fortuna property has a carrying value of \$1,012,538. In addition, the value of any intercompany book debt due to the Company will also be assigned to Morgain. The fair value of the Morgain common share consideration as at March 15, 2006 was approximately \$2.0 million. No gain on disposition will be recorded as the transaction will be accounted for as a non-monetary exchange. This mineral property has been classified as held for sale on the consolidated balance sheet. Shareholder and regulatory approvals are not required for the sale of La Fortuna by the Company.

**Exploration and mine development activities**

During 2005, the Company invested \$4.7 million in exploration and development activities. This investment was lower than the budgeted level of \$6 million. The Company experienced slower than anticipated underground drift development and delayed surface drilling due to

weather related issues and longer than anticipated negotiations for surface access to drill sites.

Exploration activities during the year were focused on areas in close proximity to the Estrella Pit, specifically El Salto, Mina Vieja and Escondida. A breakdown of the exploration expenditures by project is presented in the table below:

<b>Project name</b>	<b>2005 (\$000)</b>	<b>2004 (\$000)</b>
Escondida	1,403	-
Mina Vieja/Mulatos	1,173	472
El Salto	198	-
Bajos	485	578
El Realito	314	342
El Victor	513	-
Jaspe	306	-
Other	258	88
	<b>4,650</b>	<b>1,480</b>

The El Salto resource area is located directly northeast of the Estrella Pit, and Mina Vieja adjoins the El Salto area to the east and is the site of the historic production at Mulatos. A reserve estimate is expected shortly to add to the proven and probable reserves currently at Estrella. The timeline for completion of the reserve estimate was extended in order to complete 26 drill holes not in the original plans that were added to follow mineralization extensions, and to complete additional check assays at the request of the consultant completing the resource model.

A development drift connecting the Escondida and El Victor zones was initiated to complete development drilling from underground along a two-kilometer mineralized structural corridor. Approximately 1,083 meters of a total 1,775 meter drift has been completed from portals at opposing ends of the drift. A third drift with 185 meters of total development has been completed for underground drill access in the eastern portion of the El Victor zone. Good ore-grade continuity has been established in the development zones. Most of the development muck taken from the drift (93% from the Escondida portal and 64% from El Victor) has been ore-grade material averaging over 1.0 g/t. A total of 9,381 tonnes of material at 1.37 g/t gold has been trucked to the leach pad from the Escondida drift and 9,393 tonnes at 0.96 g/t gold from El Victor.

Drill stations have been established for drilling of a minimum of 70 holes, with two underground core rigs currently drilling in the Escondida zone and one at El Victor. To date, 52 holes (4,827 meters) have been completed at Escondida and 23 holes (1,750 meters) at El Victor. Assay results are released when the results become available.

A ventilation hole drilled from the surface into the Escondida development drift encountered a higher-grade zone at the top of the Escondida deposit, with the hole returning 12.2 g/t over 10.67 meters. Fifteen step-out reverse circulation holes intersected native gold mineralization with local bonanza grades. The best intercept was 29.0 meters of 71.0 g/t Au, including an interval of 7.6 meters of 199.0 g/t Au. A total of 52 holes (4,827 meters) have been completed in this high-grade zone.

In addition, the Company is currently drilling regional grass roots targets at El Realito (Phase II) consisting of a planned 38 hole drill campaign on a large soil gold anomaly north of previous mine workings. At the West Bajios Project, 44 holes have been drilled to date in an area of concealed thick silica alteration.

The Company has budgeted approximately \$4 million in 2006 for drifting, drilling and metallurgy for the Escondida/El Victor underground programs. Approximately \$1.6 million is planned for regional exploration, with an additional \$0.9 million intended for follow-up work, if warranted.

### **Liquidity and Capital Resources**

In February 2005, the Company issued a \$40.3 million (CDN\$50 million) 5.5% convertible unsecured subordinated debenture maturing on February 15, 2010, net of a 3.5% underwriters' fee. The debenture bears interest at an annual rate of 5.5%, payable semi-annually in arrears on February 15 and August 15 of each year. The debenture is convertible into common shares at a rate of 188.6792 common shares for each CDN\$1,000 principal amount of debentures. In certain circumstances, the debenture may be redeemed in whole or in part at the option of the Company after February 15, 2008.

The debenture is classified as a liability with the exception of the portion relating to its conversion features, which is classified as an equity component, resulting in the carrying value of the debenture being less than its face value. The discount is being accreted over the term of the debenture.

The Company has put in place an unsecured \$10 million revolving line of credit with a bank, available for general corporate purposes. Subsequent to year end on February 7, 2006 the bank increased the amount available to the Company from \$10 million to \$16 million. As at March 15, 2006, \$6 million had been drawn on this facility.

At the end of 2005 the Company had \$4.5 million in cash and cash equivalents compared to \$28.1 million (which includes short-term investments) at December 31, 2004. The Company also had \$1.2 million in funds set aside to pay interest on the convertible debentures due in February 2006, in accordance with the terms of the trust indenture. In February 2006, \$1.2 million was paid as interest to the debenture holders from the trust account, and the Company deposited an additional \$2.4 million with the debenture trustee to fund interest payments due in August 2006 and February 2007.

At December 31, 2005, the Company had \$13.0 million in working capital, a decrease from the working capital balance of \$29.0 million at December 31, 2004. Cash, cash equivalents and short-term investments were \$23.6 million lower than the balances at December 31, 2004. The Company received \$48.1 million in new funding, primarily from a \$40.3 million convertible debenture issue in February 2005, and invested \$58 million in mineral property plant and equipment, plus cash outflows of \$12.7 million from operations, including \$8.9 million for finished product, in-process precious metals and parts and supplies inventory. The investment in in-process inventory reflects the cost of pad-loading and stockpiling gold-bearing material undergoing processing into a gold/silver dore product.

Accounts payable and accrued liabilities increased from \$0.9 million at December 31, 2004 to \$5.3 million at December 31, 2005 primarily reflecting the inclusion of payables related to mining operations. Interest payable of \$0.9 million is related to the convertible debenture for

the period from the last interest payment date on August 15, 2006 to the end of the year. In the fourth quarter of 2005, the Company entered into capital lease agreements for mining equipment. The total outstanding capital lease obligation was \$4.8 million at December 31, 2005 of which the current portion of \$1.2 million is included in working capital.

The Company expects to have a Mine working capital requirement of approximately \$13-15 million throughout 2006, depending on the level of in-process precious metals and parts and supplies inventory, and the timing of recovery of refundable sales taxes, up from the current level of \$12.2 million which includes short-term contractor advances and recoverable taxes. The value of in-process inventory is expected to increase as production levels ramp up to an expected target of 15,000 tonnes of ore per day. Approximately \$1.2 million plus interest is payable annually on the Company's capital lease obligations. No principal payments are required on the debenture until February 2010.

Subsequent to December 31, 2005, the Company received over \$8 million from the exercise of stock options and warrants. The Company expects to receive an additional \$6.8 million from the exercise of warrants that are due in April 2006. With the addition of these funds and anticipated cash flow from operations, the Company expects that it will have sufficient liquidity to meet its operating, capital and working capital requirements for 2006. In addition, the Company has \$10 million in unused lines of credit. The Company expects to extend the term of its existing credit facility after July 2006, but has not yet entered into discussions with its lender.

### **Off-Balance Sheet Arrangements**

The Company has entered into certain foreign exchange forward and gold sales contracts which may, in certain circumstances, be classified as off-balance sheet arrangements. In 2005, due to the nature of the contracts entered into, the mark-to-market value of these contracts was recorded on the balance sheet.

The Company has entered into agreements to acquire \$16 million Canadian dollars in 2007, and \$10 million Canadian dollars in the first quarter of 2006 at a fixed price to offset a portion of its Canadian dollar debenture liability which is not offset by Canadian dollars on deposit. As at December 31, 2005, the Company had recorded an unrealized foreign exchange gain of \$1.1 million on these contracts. After December 31, 2005 one contract to acquire CDN\$6.0 million at a fixed cost of 1.1952 came due and was not renewed or extended, resulting in a realized foreign exchange gain of \$174,000.

At year end, the Company had contracts to sell 2,000 ounces of gold to a counter-party in January 2006, resulting in a mark-to-market loss of \$93,600 recorded as an unrealized forward contract loss. If the contracts had qualified for hedge accounting treatment and the Company designated the contracts as hedges, the value of the contracts would have been recorded only in the future sales period designated by the Company.

### **Commitments Table (by period)**

The following table presents information with respect to the Company's contractual obligations as at December 31, 2005:

**PAYMENTS DUE BY PERIOD (\$)**

<b>CONTRACTUAL OBLIGATIONS</b>	<b>TOTAL</b>	<b>LESS THAN 1 YEAR</b>	<b>2- 3 YEARS</b>	<b>4 – 5 YEARS</b>	<b>MORE THAN 5 YEARS</b>
Long-term debt obligations <sup>(1)</sup>	52,320,000	2,360,000	4,720,000	45,240,000	-
Bank debt	3,000,000	3,000,000			
Capital lease Obligations <sup>(2)</sup>	5,900,000	1,200,000	2,400,000	2,300,000	-
Future currency purchases	26,000,000	10,000,000	16,000,000	-	-
Liabilities reflected on the Company's Balance Sheet under the GAAP of the primary financial statements <sup>(3)</sup>	4,264,000	-	-	-	4,264,000
<b>Total</b>	<b>91,484,000</b>	<b>16,560,000</b>	<b>23,120,000</b>	<b>47,540,000</b>	<b>4,264,000</b>

Contractual obligations exclude expenses, except as noted, of a fixed nature expected to be incurred in the normal course of operations.

- (1) Based on December 31, 2005 US/CDN exchange rate. The Company issued CDN\$50 million (\$40.3 million) in convertible debentures due in February, 2010, unless converted into common shares of the Company at the option of the holder, with an annual interest rate of 5.5%.
- (2) Cash flows relating to capital leases, presented on a non-discounted cashflow basis
- (3) Estimated asset retirement obligations, presented on a non-discounted cashflow basis.

Production royalties, on a sliding scale to the price of gold, at 5% of gold revenue with gold above \$400 per ounce, are a contractual obligation once commercial production (as defined in the agreement) is attained, but cannot reasonably be estimated as they are a function of the price of gold and production rate, neither of which can be ascertained with any certainty.

### **Related Party Transactions**

The Company received consulting services from one director on a fee for services plus retainer basis, resulting in an ongoing commitment. Total contractual fees paid were

\$69,440 compared to \$475,723 paid in 2004 to a director and officer of the Company. In 2004, consulting services were subject to the terms of an annual renewable services contract for an officer and director. The form of this services contract was discontinued in the fourth quarter of 2004. These transactions have occurred in the normal course of operation and are measured at their fair value.

### **New Accounting Policies**

In the third quarter of 2005, the Company achieved its first gold production from the Mulatos Mine. Accordingly, new accounting policies related to revenue recognition, in-process precious metals inventory and parts and supplies inventory were adopted. The Company also entered into long-term leases which are accounted for as capital leases based on the terms of the agreements.

Under "Critical Accounting Estimates" below, the impact of adopting a more conservative approach to accounting for exploration and development expenditures is presented. This policy was adopted retroactively with restatement of prior periods and resulted in increasing the loss in 2004 by \$994,591 and in 2005 by \$1,889,060 from the loss that would have been recorded in those years had the Company maintained its previous accounting policy for exploration and development expenditures.

### **Outstanding Share Data**

The table below describes the terms associated with the Company's outstanding and diluted share capital:

	<b>As at March 15, 2006</b>
<b>Common shares</b>	
- Common shares outstanding	<b>80,306,632</b>
<b>Warrants</b>	
- Exercisable at CDN\$3.50 until expiry on April 8, 2006	2,262,500
- Exercisable at CDN\$5.80 until expiry on July 21, 2007	350,000
	<b>2,612,500</b>
<b>Stock options</b>	
- Average exercise price CDN\$3.04. Approximately 90% vested.	<b>4,661,983</b>
<b>Convertible debentures</b>	
- Face value CDN\$50 million. Convertible into common shares at a rate of 188.6792 common shares for each CDN\$1,000 principal amount of debentures.	9,433,960
<b>Diluted number of common shares outstanding</b>	<b>97,015,075</b>

### **Internal Control**

Management is responsible for the design of internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements in accordance with accounting principles generally

accepted in Canada. Based on a review of its internal control procedures at the end of the period covered by this MD&A, management believes its internal controls and procedures are effective in providing reasonable assurance that financial information is recorded, processed, summarized and reported in a timely manner.

Management is also responsible for the design and effectiveness of disclosure controls and procedures to provide reasonable assurance that material information related to the Company, including its consolidated subsidiaries, is made known to the Company's certifying officers. The Company's Chief Executive Officer and Chief Financial Officer have each evaluated the effectiveness of the Company's disclosure controls and procedures as of December 31, 2005 and have concluded that these controls and procedures are effective in providing reasonable assurance that material information relating to the Company is made known to them by others within the Company.

In 2005, new internal controls were implemented at the Company's Mine operations for expenditures, revenue recognition and in-process precious metals inventory. A new purchasing, warehousing, accounting and reporting software package is being implemented in conjunction with the new mining operation. New payroll software and administration will replace a third-party payroll service, and new process controls will be implemented for that function.

### **Critical Accounting Estimates**

The preparation of financial statements in conformity with Canadian GAAP requires the Company to select from possible alternative accounting principles, and to make estimates and assumptions that determine the reported amounts of assets and liabilities at the balance sheet date, and reported costs and expenditures during the reporting period. Estimates and assumptions may be revised as new information is obtained, and are subject to change. The Company's accounting policies and estimates used in the preparation of the consolidated financial statements are considered appropriate in the circumstances, but are subject to judgments and uncertainties inherent in the financial reporting process.

The Company recently changed its accounting policy for mineral development expenditures, in conjunction with establishing itself as a gold producer. The Company follows a relatively conservative policy for recording mineral property acquisition costs and related mineral exploration and development expenditures. Property acquisition costs are capitalized until the properties are either placed into production, sold, abandoned or written down, where appropriate. Where the fair value of the property cannot be supported objectively through a cash flow analysis due to a lack of measured proven and probable reserves, the Company looks to other indicators of value, such as recent property sales for other properties in a similar locale and at a similar stage of development. The Company's accounting policy for mineral exploration and development expenditures is to expense exploration costs on new projects which do not contain proven and probable reserves until such reserves are objectively established, except where a property is contiguous with a mineral property that has proven and probable reserves, and it is reasonable to believe that further drilling or other means of development can extend proven and probable reserves to that mineral property. The policy is consistent with other mining companies in Canada and is consistent in all material respects with the procedures prescribed by the Securities and Exchange Commission in the United States. The change in accounting policy will result in a lower level of recorded assets and higher deficit each year. Annual

exploration expense will more accurately reflect expenditures incurred during the year rather than decisions to write-off a property and related expenditures when it is determined to be uneconomic.

The Company accounts for its in-process precious metals inventory using a process flow for applicable costs appropriate to the physical transformation of ore through the mining, crushing, leaching and gold recovery process. The Company is required to estimate the ultimate recovery of payable metals from laboratory tests and from ongoing analysis of leach pad kinetics in order to determine the recoverable metals from the leach pad at the end of each accounting period. If the Company determines at any time that the ultimate recovery should be adjusted downward, then the Company will adjust the average carrying value of a unit of metal content in the in-process inventory and adjust upward on a prospective basis the unit cost of subsequent production. Should an upward adjustment in the average carrying value of a unit of metal result in the carrying value exceeding the realizable value of the metal, the Company would write down the carrying value to the realizable value.

The Company follows accounting guidelines in determining the fair value of stock-based compensation, as disclosed in Note 15 to the Financial Statements. This calculated amount is not based on historical cost, but is derived based on subjective assumptions input into an option pricing model. The model requires that management make several assumptions as to future events, including: an estimate of the average future hold period of issued stock options before exercise, expiry or cancellation; future volatility of the Company's share price in the expected hold period (using historical volatility as a reference); and the appropriate risk-free rate of interest. The resulting value calculated is not necessarily the value that the holder of the option could receive in an arm's length transaction, given that there is no market for the options and they are not transferable. It is management's view that the value derived is highly subjective and dependent entirely upon the input assumptions made. The fair value of the compensation is either expensed or capitalized as a mineral property development cost depending on the nature of the grant. One factor which may serve to reduce the value of future grants is the expected lower volatility of the Company's share price as it makes a transition from an exploration company to a producing company. Conversely, a higher expected share price may serve to increase the value of future grants.

The Company is required to determine the expected value of the estimated costs of asset retirement obligations and to recognize this value as a liability when reasonably determinable. This valuation is added to the cost of the relevant mineral property on the consolidated balance sheets, and amortized as an expense in the consolidated statements of operations when the mineral property is in production. Asset retirement costs include future removal and site restoration. Key assumptions in determining the amount of liability are total undiscounted cash outflows; expected timing of payment of the cash outflows; and appropriate discount rates to apply to the timing of cash outflows. Because the liability is recorded on a discounted basis, it is increased due to the passage of time with an offsetting charge to accretion expense in the statement of operations. The Company conducted an initial study in 2005 and will update it from time to time as more information becomes available. Most reclamation will occur at the end of the mine life, expected to be in 10 years based on expected mine proven and probable reserves and rate of mining.

## **Outlook**

The Company expects to update its reserve estimate at the Mine shortly, encompassing recent infill drilling at El Salto/Mina Vieja. The Company also anticipates that drilling at Escondida will result in resource and proven and probable reserve revisions in 2006.

The Mine will continue to expand production to achieve its target of 15,000 tonnes per day. Crusher throughput is currently averaging over 6,000 tonnes per day over a 30-day period, with peak throughput exceeding 11,000 tonnes per day. Crusher production is supplemented with run-of-mine material. Over 904,500 tonnes grading 1.6 g/t gold have been placed on the leach pad in the first 74 days of 2006.

Production in 2006 is expected to be between 140,000 and 155,000 ounces of gold at an average cash operating cost (exclusive of royalties) of between \$210 and \$225 per ounce of gold. Cash operating costs are expected to be higher at the beginning of 2006 as higher cost in-process inventory from 2005 gets processed on site as dore and is subsequently refined and sold.

Exploration activities are expected to continue at several targets within the Salamandra group of concessions. The Company is also looking to complete the drill program on the Escondida Hanging Wall Zone and outline the extent of mineralization, as well as complete the Escondida and El Victor underground drilling. Underground mineral development will continue through the Gap zone with drift completion scheduled for the third quarter of 2006.

## **Risk Factors and Uncertainties**

The financing, exploration, development and mining of any of the Company's properties is subject to a number of factors including the price of gold, laws and regulations, political conditions, currency fluctuations and hiring qualified people and obtaining necessary services in jurisdictions where the Company operates. The current trends relating to these factors are favourable but could change at any time and negatively affect the company's operations and business.

The following is a brief discussion of those distinctive or special characteristics of the Company's operations and industry which may have a material impact on, or constitute risk factors in respect of the Company's future financial performance:

## **Industry**

The Company is engaged in exploration, mine development and the mining and production of precious metals, primarily gold, and is exposed to a number of risks and uncertainties that are common to other companies in the same business. Unusual or unexpected formations, formation pressures, fires, power outages, labour disruptions, flooding, cave-ins, landslides and the inability to obtain suitable adequate machinery, equipment or labour are risks involved in the operation of mines and the conduct of exploration programs. The Company has relied on and may continue to rely upon consultants and others for mine operating and exploration expertise. Few properties that are explored are ultimately developed into producing mines. Substantial expenditures are required to establish ore reserves through drilling, to develop metallurgical processes to extract the metal from the ore and in the case of new properties, to develop the mining and processing facilities and infrastructure at any site chosen for mining. Although substantial benefits may be derived from the discovery of a major mineral deposit,

the Company may not be able to raise sufficient funds for development. The economics of developing mineral properties is affected by many factors including the cost of operations, variations in the grade of ore mined, fluctuations in metal markets, costs of processing equipment and such other factors as government regulations, including regulations relating to royalties, allowable production, importing and exporting of minerals and environmental protection. Where expenditures on a property have not led to the discovery of mineral reserves, spent costs will not usually be recoverable.

### **Commodity Price**

The value of the Company's mineral resources and future operating profit and loss is affected by fluctuations in gold prices, over which the Company has no control. A reduction in the price of gold may prevent the Company's properties from being economically mined or result in the write-off of assets whose value is impaired as a result of low gold prices. The price of gold may also have a significant influence on the market price of the Company's common shares and the value of the Company's properties. The price of gold is affected by numerous factors beyond the Company's control, such as the level of inflation, fluctuation of the United States dollar and foreign currencies, global and regional demand, sale of gold by central banks and the political and economic conditions of major gold producing countries throughout the world. The price of gold has increased significantly in the past several years. As of December 31, 2005, the London PM Gold fix closing price for gold was US\$513.00 per ounce. The current gold price is significantly above impairment levels. The Company has elected not to engage in significant forward selling, as a number of gold mining companies have been adversely affected by maintaining a substantial forward sales book in the face of a rising gold market. At the 2006 expected rate of production, a \$1 change in the price of gold per ounce would change revenue, income and cash flow by approximately \$150,000 annually, before tax charges.

### **Currency**

The Company is subject to currency risks. The Company's functional currency is the United States dollar, which is subject to recent fluctuations against other currencies. The Company's primary operations are located in Mexico and many of its expenditures and obligations are denominated in Mexican pesos. The Company maintains its principal office in Canada, maintains cash accounts in U.S. dollars, Mexican pesos and Canadian dollars and has monetary assets and liabilities in U.S. and Canadian dollars and Mexican pesos. Specifically, the Company's convertible debenture liability of CDN\$50 million is denominated in Canadian dollars. The currency exchange rate between U.S. dollars and Canadian dollars fluctuated between US\$0.7854 to US\$0.8754 for CDN\$1 in 2005 and US\$0.7156 to US\$0.8491 for CDN\$1 in 2004. As such, the Company's results of operations are subject to foreign currency fluctuation risks and such fluctuations may adversely affect the financial position and operating results of the Company. While the Company has mitigated some balance sheet risk for Canadian dollar liabilities, it has not undertaken to mitigate transactional volatility in either the Mexican peso or the Canadian dollar at this time. A 1% change in Canadian dollar valuation would impact administration costs by approximately \$25,000 annually; a 1% change in Mexican peso valuation would impact operating costs by approximately \$200,000 annually.

## **Business**

The Company has limited financial resources which could affect its ability to carry out its business plan. The Company's ability to secure fixed gold prices or future foreign exchange rates is affected by its creditworthiness. Because of its limited operating record and history of losses, it may not be able to hedge future risk to the extent it feels is appropriate. The Company's ability to obtain financing to explore for mineral deposits and to continue and complete the development of those properties it has classified as assets is not assured, nor is there assurance that the expenditure of funds will result in the discovery of an economic mineral deposit.

## **Competitive**

The Company's business is intensely competitive, and the Company competes with other mining companies, many of which have greater resources and experience. Competition in the precious metals mining industry is primarily for mineral rich properties which can be developed and produced economically; the technical expertise to find, develop, and produce such properties; the labour to operate the properties; and the capital for the purpose of financing development of such properties. Many competitors not only explore for and mine precious metals, but conduct refining and marketing operations on a world-wide basis and some of these companies have much greater financial and technical resources than the Company. Such competition may result in the Company being unable to acquire desired properties, recruit or retain qualified employees or acquire the capital necessary to fund its operations and develop its properties. The Company's inability to compete with other mining companies for these mineral deposits could have a material adverse effect on the Company's results of operations and business.

## **Country**

The Company conducts exploration, mine development and mining and production activities in Sonora, Mexico. Mexico is a developing country and obtaining financing, finding or hiring qualified people or obtaining all necessary services for the Company's operations in Mexico may be difficult. Mexico's status as a developing country may make it more difficult for the Company to attract investors or obtain any required financing for its mining projects.

The acquisition of the right to exploit mineral properties is a detailed and time-consuming process. Although the Company is satisfied it has taken reasonable measures to ensure an unencumbered right to exploit the Salamandra Concessions, no assurance can be given that such claims are not subject to prior unregistered agreements or interests or to undetected or other claims or interests which could be material and adverse to the Company.

While the Company has entered into a surface agreement with the Ejido Mulatos and has entered into agreements to purchase all of the surface rights covered by that agreement from the individual Ejido members to whom they have been assigned, the transfers of title to these surface rights are currently being registered under Mexican law. The registration process is a lengthy one and until title to the properties is registered in the Company's name, the Company cannot be certain of enjoying undisputed rights to the surface rights or that registration will be completed as planned or at all.

## **Environmental**

The operations of the Company are subject to environmental regulations promulgated by government agencies from time to time. Specifically, the Company activities related to its Salamandra Concessions are subject to regulation by SEMARNAP, the environmental protection agency of Mexico. Regulations require that an environmental impact statement, known in Mexico as a *Manifiesto Impacto Ambiental*, be prepared by a third-party contractor for submittal to SEMARNAP. Studies required to support the *Manifiesto Impacto Ambiental* include a detailed analysis of the following areas: soil, water, vegetation, wildlife, cultural resources and socio-economic impacts. The Company must also provide proof of local community support for a project to gain final *Manifiesto Impacto Ambiental* approval. Environmental legislation provides for restrictions and prohibitions on spills, releases or emissions of various substances produced in association with certain mining industry operations, such as seepage from tailings disposal areas, which would result in environmental pollution. A breach of such legislation may result in imposition of fines and penalties. In addition, certain types of operations require the submission and approval of environmental impact assessments. Environmental legislation is evolving in a manner which means stricter standards, and enforcement, fines and penalties for non-compliance are more stringent. Environmental assessments of proposed projects carry a heightened degree of responsibility for companies and directors, officers and employees. The cost of compliance with changes in governmental regulations has the potential to reduce the profitability of operations.

## **Regulatory**

The Company's activities are subject to extensive laws and regulations governing worker health and safety, employment standards, waste disposal, protection of historic and archaeological sites, mine development, protection of endangered and protected species and other matters. Specifically, the Company's activities related to its Mulatos Mine and the Salamandra group of concessions are subject to regulation by SEMARNAP, the environmental protection agency of Mexico, *Comisión Nacional del Agua* ("CAN"), which regulates water rights, and the Mexican Mining Law. Mexican regulators have broad authority to shut down and/or levy fines against facilities that do not comply with regulations or standards. The Company' mineral exploration and mining activities in Mexico may be adversely affected in varying degrees by changing government regulations relating to the mining industry or shifts in political conditions that increase the costs related to the Company activities or maintaining its properties. Operations may also be affected in varying degrees by government regulations with respect to restrictions on production, price controls, export controls, income taxes, expropriation of property, environmental legislation and mine safety.

A number of other approvals, licenses and permits are required for various aspects of mine development. While the Company has used its best efforts to ensure title to all its properties and secured access to surface rights, these titles or rights may be disputed, which could result in costly litigation or disruption of operations. The Company is uncertain if all necessary permits will be maintained on acceptable terms or in a timely manner. Future changes in applicable laws and regulations or changes in their enforcement or regulatory interpretation could negatively impact current or planned exploration and development activities within the Company's Salamandra Concessions or any other projects with which the Company becomes involved. Any failure to comply with applicable laws and regulations or failure to obtain or maintain permits, even if inadvertent, could result in the interruption of exploration and development operations or material fines, penalties or other liabilities.

## **Estimates**

The mineral reserves and resource estimates of the Company are estimates only and no assurance can be given that any particular level of recovery of minerals will in fact be realized or that an identified reserve or resource will ever qualify as a commercially mineable (or viable) deposit which can be legally and economically exploited. In addition, the grade of mineralization ultimately mined may differ from that indicated by drilling results and such differences could be material. Production can be affected by such factors as permitting regulations and requirements, weather, environmental factors, unforeseen technical difficulties, unusual or unexpected geological formations, inaccurate or incorrect geologic, metallurgical or engineering work, and work interruptions, among others. Short term factors, such as the need for orderly development of deposits or the processing of new or different grades, may have an adverse effect on mining operations or the results of operations. There can be no assurance that minerals recovered in small scale laboratory tests will be duplicated in large scale tests under on-site conditions or in production scale operations. Material changes in proven and probable reserves or resources, grades, waste-to-ore ratios or recovery rates may affect the economic viability of projects. The estimated proven and probable reserves and resources described herein should not be interpreted as assurances of mine life or of the profitability of future operations. Based on expected 2006 production rates, a 1% change in expected rate of recovery of gold from ores would result in a \$3 per ounce change in cash costs, and approximately \$450,000 change in income and cash flow annually, before tax charges. A 1% change in cash cost per tonne of ore would result in a \$2 per ounce change in cash cost, and approximately \$300,000 change in income and cash flow annually, before tax charges.

## **Dependence on Management**

The Company is dependent on key personnel and the absence of any of these individuals could result in a significantly negative effect on the Company. The Company strongly depends on the business and technical expertise of its management and key personnel. There is little possibility that this dependence will decrease in the near term. As the Company's operations expand, additional general management resources will be required, especially since the Company encounters risks that are inherent in doing business in several countries. The Company is dependent, in particular, on its President and Chief Executive Officer, John McCluskey and its Chief of Operations, John Van De Beuken. Key man life insurance is not in place on Messrs. McCluskey or Van De Beuken. If the services of the Company's management and key personnel were lost, it could have a material adverse effect on future operations.

## **Legal**

Substantially all of the Company's assets are located outside of Canada, and are held indirectly through foreign affiliates. It may be difficult or impossible to enforce judgments obtained in Canadian courts predicated upon the civil liability provisions of the securities laws of certain provinces against the portion of the Company's assets located outside of Canada.

## **Forward-Looking Statements**

Except for historical information contained in this discussion and analysis, disclosure statements contained herein are forward-looking, as defined in the United States Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to risks

and uncertainties, which could cause actual results to differ materially from those in such forward-looking statements.

This MD&A contains forward-looking statements concerning the Company's plans for its properties and other matters within the meaning of Section 21E of the Securities Exchange Act of the United States. Forward-looking statements include, but are not limited to, statements with respect to anticipated commencement dates of mining production, operations, projected quantities of future metal production, anticipated production rates and mine life, operating efficiencies, costs and expenditures and conversion of mineral resources to proven and probable reserves, and other information that is based on forecasts of future results, estimates of amounts not yet determinable and assumptions of management.

Statements concerning proven and probable reserves and mineral resource estimates may also be deemed to constitute forward-looking statements to the extent that they involve estimates of the mineralization that will be encountered if the property is developed, and in the case of mineral resources or mineral reserves, such statements reflect the conclusion based on certain assumptions that the mineral deposit can be economically exploited. Any statements that express or involve discussions with respect to predictions, expectations, beliefs, plans, projections, objectives, assumptions or future events or performance (often, but not always, using words or phrases such as "expects" or "does not expect", "is expected", "anticipates" or "does not anticipate", "plans", "estimates" or "intends", or stating that certain actions, events or results "may", "could", "would", "might" or "will" be taken, occur or be achieved) are not statements of historical fact and may be "forward-looking statements." Forward-looking statements are subject to a variety of risks and uncertainties which could cause actual events or results to differ from those reflected in the forward-looking statements.

The nature of risks and uncertainties are discussed more fully in the Annual Information Form filed by the Company available at [www.sedar.com](http://www.sedar.com).