

# **Malaga Inc.**

Unaudited Condensed Interim  
Consolidated Financial Statements

For the three-month and nine-month periods ended  
September 30, 2011

These unaudited condensed interim consolidated financial statements have not been reviewed by the external auditors of the Company.

# Malaga Inc.

Consolidated Statement of Financial Position as at  
(Unaudited; Expressed in US dollars)

	September 30, 2011 \$	December 31, 2010 \$
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	480,058	2,840,595
Trade and other receivables (Note 5)	1,442,066	2,013,770
Income tax instalments receivable	894,417	824,199
Inventories (Note 6)	1,782,187	2,100,100
Prepaid expenses	249,987	203,078
	<u>4,848,715</u>	<u>7,981,742</u>
<b>NON-CURRENT ASSETS</b>		
Investments in associates (Note 7)	199,637	200,000
Investment (Note 8)	1,860,397	4,644,534
Property, plant and equipment (Note 9)	16,710,801	13,076,045
Mining properties and deferred development and exploration costs (Note 10)	6,346,919	4,772,885
	<u>25,117,754</u>	<u>22,693,464</u>
	<u>29,966,469</u>	<u>30,675,206</u>
<b>LIABILITIES</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued liabilities (Note 11)	2,573,047	3,442,905
Unearned revenues	1,350,466	896,777
Current portion of long-term debt (Note 12)	1,309,932	1,241,049
Current portion of obligations under finance leases	135,316	132,825
	<u>5,368,761</u>	<u>5,713,556</u>
<b>NON-CURRENT LIABILITIES</b>		
Long-term debt (Note 12)	2,738,006	3,324,188
Deferred revenues (Note 12)	743,713	966,832
Obligations under finance leases	158,556	65,817
Warrants liability (Note 13)	165,867	2,713,995
Asset retirement obligation	583,105	568,718
	<u>4,389,247</u>	<u>7,639,550</u>
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (Note 14)	39,238,796	39,200,848
Broker Warrants	30,381	30,381
Contributed surplus	3,801,707	3,466,211
Accumulated other comprehensive income	(1,910,107)	-
Deficit	(20,952,316)	(25,375,340)
	<u>20,208,461</u>	<u>17,322,100</u>
	<u>29,966,469</u>	<u>30,675,206</u>

On behalf of the Board of Directors

(s) Jean Martineau  
Jean Martineau

(s) Gilles Masson  
Gilles Masson

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

**Malaga Inc.**

## Consolidated Statements of Comprehensive Income (Loss)

(Unaudited; Expressed in US dollars)

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2011 \$	2010 \$	2011 \$	2010 \$
Sales (Note 15)	4,643,977	3,790,794	15,229,932	10,847,707
Cost of sales (Note 15)	(3,058,094)	(3,382,548)	(9,784,073)	(9,863,998)
Income from mining operations	1,585,883	408,246	5,445,859	983,709
General and administrative expenses (Note 15)	(853,144)	(714,962)	(2,997,680)	(2,300,936)
Operating income (loss)	732,739	(306,716)	2,448,179	(1,317,227)
Financial expenses (Note 15)	(149,541)	(276,600)	(438,828)	(960,696)
Foreign exchange gain (loss)	110,617	95,119	(145,610)	171,921
Share of earnings in investment using equity method	(6,717)	(123,335)	(363)	(24,784)
Gain (loss) on sale of available-for-sale investment	(54,429)	-	43,818	-
Change in fair value of the promissory note receivable	-	188,514	-	992,412
Gain (loss) on revaluation of warrants (Note 13)	1,347,781	(504,680)	2,515,828	(504,680)
Income (loss) before income taxes	1,980,450	(927,698)	4,423,024	(1,643,054)
Future income tax expense	-	-	-	-
Net income (loss)	1,980,450	(927,698)	4,423,024	(1,643,054)
Other comprehensive income, net of income taxes: Net variation in the latent loss on available-for- sale investments	(1,079,077)	-	(1,910,107)	-
Comprehensive Income (loss) for the period	901,373	(927,698)	2,512,917	(1,643,054)
Earnings (loss) per share (Note 16)				
Basic	\$0.01	(\$0.01)	\$0.02	(\$0.01)
Diluted	\$0.01	(\$0.01)	\$0.02	(\$0.01)
Weighted average number of outstanding common shares				
Basic	183,675,176	183,550,176	183,602,923	163,913,619
Diluted	205,019,525	185,114,926	204,947,272	165,033,927

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

The consolidated statements of comprehensive income (loss) above is disclosed by function.

**Malaga Inc.**

## Consolidated Statements of Changes in Equity

(Unaudited; Expressed in US dollars)

	Share Capital \$	Broker Warrants \$	Contributed surplus \$	Accumulated other comprehensive income \$	Deficit \$	Total equity \$
<b>Balance, January 1, 2011</b>	39,200,848	30,381	3,466,211	-	(25,375,340)	17,322,100
Net income for the period					4,423,024	4,423,024
Changes in fair value of available-for-sale assets (net of tax)				(1,910,107)		(1,910,107)
Comprehensive Income for the period				(1,910,107)	4,423,024	2,512,917
Stock-based compensation (Note 14)			352,480			352,480
Exercise of options (Note 14)	37,948		(16,984)			20,964
<b>Balance – September 30, 2011</b>	39,238,796	30,381	3,801,707	(1,910,107)	(20,952,316)	20,208,461
	Share Capital \$	Broker Warrants \$	Contributed surplus \$	Accumulated other comprehensive income \$	Deficit \$	Total equity \$
<b>Balance, January 1, 2010</b>	35,165,941	-	3,177,756	-	(26,611,322)	11,732,375
Net loss and comprehensive loss for the period					(1,643,054)	(1,643,054)
Common shares issued	4,479,372					4,479,372
Share issuance expenses (Note 14)	(442,517)					(442,517)
Issuance of broker warrants (Note 14)		30,381				30,381
Stock-based compensation (Note 14)			329,936			329,936
<b>Balance – September 30, 2010</b>	39,202,796	30,381	3,507,692	-	(28,254,376)	14,486,493

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

**Malaga inc.**

## Consolidated Statements of Cash Flows

(Unaudited; Expressed in US dollars)

	Three month periods ended September 30,		Nine-month period ended September 30,	
	2011 \$	2010 \$	2011 \$	2010 \$
<b>Operating activities</b>				
Net income (loss)	1,980,450	(927,698)	4,423,024	(1,643,054)
Items not affecting cash				
Depreciation and depletion	562,348	716,518	1,836,892	2,207,632
Amortization of deferred revenues	(74,373)	(74,373)	(223,119)	(223,119)
Accretion expense of asset retirement obligation	4,826	4,490	14,387	13,658
Accretion expense of long-term debt	129,210	152,411	405,656	460,881
Stock-based compensation	20,038	45,177	352,480	329,936
Gain on settlement of debt	(53,951)	(58,329)	(165,138)	(117,632)
Share of earnings in investments using equity method	6,717	123,335	363	24,784
Interest to former workers and employees	-	27,237	-	315,810
Gain (loss) on sale of available-for-sale investment	54,429	-	(43,818)	-
Gain on revaluation of warrants	(1,347,781)	504,680	(2,515,828)	504,680
Loss on variation of the fair market value of the promissory note	-	(188,514)	-	(992,412)
Unrealized foreign exchange (gain) loss	(128,155)	(153,222)	50,874	(32,967)
	<u>1,153,758</u>	<u>171,712</u>	<u>4,135,773</u>	<u>848,197</u>
Change in non-cash working capital items (Note 17)	604,216	529,949	306,573	(1,781,910)
	<u>1,757,974</u>	<u>701,661</u>	<u>4,442,346</u>	<u>(933,713)</u>
<b>Investing activities</b>				
Net proceeds from sale of investment	194,304	-	917,848	-
Investment in Hidroeléctrica Pelagatos S.A.C.	-	-	-	(200,000)
Acquisition of property, plant and equipment	(1,610,611)	(1,112,290)	(5,164,874)	(2,263,968)
Additions to mining properties and deferred development and exploration costs	(719,645)	(366,187)	(1,574,034)	(684,927)
	<u>(2,135,952)</u>	<u>(1,478,477)</u>	<u>(5,821,060)</u>	<u>(3,148,895)</u>
<b>Financing activities</b>				
Repayment of long-term debt	(293,630)	(337,867)	(856,798)	(648,154)
Proceeds of issuance of common shares	-	-	20,964	4,479,372
Share capital issuance cost	-	(8,069)	-	(442,517)
Proceeds of issuance of ordinary warrants	-	-	-	30,381
Proceeds of issuance of broker warrants	-	-	-	689,150
Re-payment of obligations under finance leases	(47,298)	(67,877)	(145,989)	(197,366)
	<u>(340,928)</u>	<u>(413,813)</u>	<u>(981,823)</u>	<u>3,910,866</u>
Variation in cash during the period	(718,906)	(1,190,629)	(2,360,537)	(171,742)
Cash, beginning of the period	1,198,964	2,112,228	2,840,595	1,093,341
<b>Cash, end of the period</b>	<u>480,058</u>	<u>921,599</u>	<u>480,058</u>	<u>921,599</u>
<b>Additional information:</b>				
Interest paid	69,456	178,028	183,923	603,789
Income taxes paid	-	-	-	4,916

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

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

September 30, 2011 and 2010

(Unaudited; Expressed in US dollars **except where otherwise indicated**)

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### 1. Statute of Incorporation and Nature of Activities

Malaga Inc. ("Malaga" or the "Company"), is incorporated under Part 1A of the Companies Act (Quebec) and as of February 14, 2011 is governed under the Business Corporations Act (Québec). Malaga, including its subsidiaries, is a mining company that operates mainly in Peru at its tungsten mine in Pasto Bueno.

The Company and its subsidiaries also have interests in mining properties currently at the exploration or development stage. Certain of these properties are in the process of evaluation to determine the economics of putting them into production. The potential for recovery of the costs incurred on these properties and of the related deferred charges depends on the existence of sufficient quantities of reserves, obtaining all the required permits, the Company's ability to obtain appropriate financing to put these properties into production, and the ability to realize a profitable return.

### 2. Basis of preparation and first time adoption of IFRS

These condensed interim consolidated financial statements have been prepared by the Company's management in accordance with *International Financial Reporting Standards* ("IFRS"), and in accordance with International Accounting Standards "IAS" 34 "Interim Financial Reporting". They do not include all the information required in annual financial statements in accordance with IFRS. As these financial statements represent the Company's initial presentation of its results and financial position under IFRS, they have been prepared in accordance with IFRS 1, "First-time Adoption of International Financial Reporting Standards".

These condensed interim consolidated financial statements have been prepared in accordance with the accounting policies the Company expects to adopt in its December 31, 2011 financial statements. Those accounting policies are based on the published IFRS standards applicable at that time. The policies described in Note 3 of the Company's interim condensed consolidated financial statements for the quarters ended March 31, 2011 and June 30, 2011 were consistently applied to all the periods presented. The policies applied in these condensed interim consolidated financial statements are based on IFRS issued and outstanding as at November 11, 2011, the date the Board of Directors approved these condensed interim consolidated financial statements for release. Any subsequent changes to IFRS that are issued and effective as at December 31, 2011 could result in a restatement of these condensed interim consolidated financial statements, including the transition adjustments recognized on conversion to IFRS.

The Company prepares its financial statements in accordance with Canadian generally accepted accounting principles as set out in the Handbook of the Canadian Institute of Chartered Accountants ("CICA Handbook"). In 2010, the CICA Handbook was revised to incorporate International Financial Reporting Standards and require publicly accountable enterprises to apply such standards effective for years beginning on or after January 1, 2011. Accordingly, the Company has reported on this basis in these interim condensed consolidated financial statements. In these financial statements, the term "Canadian GAAP" refers to Canadian GAAP before the adoption of IFRS. Subject to certain transition elections, which are disclosed in Note 18, the Company has consistently applied the same accounting policies in its opening IFRS consolidated balance sheet as at January 1, 2010 and throughout all periods presented, as if these policies had always been in effect. Note 18 discloses the impact of the transition to IFRS on the Company's reported financial position, financial performance and cash flows, including the nature and effect of significant changes in accounting policies from those used in the Company's last annual financial statements.

These condensed interim consolidated financial statements should be read in conjunction with the Company's 2010 annual financial statements, which were prepared in accordance with Canadian GAAP, as well as the Company's interim condensed consolidated financial statements for the quarters ended March 31, 2011 and June 30, 2011, which were prepared in accordance with IFRS applicable to interim financial statements.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the company's accounting policies. Please refer to Note 4 for details.

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

September 30, 2011 and 2010

(Unaudited; Expressed in US dollars **except where otherwise indicated**)

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### 3. Accounting standards issued but not yet applied

The IASB issued the following standards which are relevant but have not yet been adopted by the Company: IFRS 9, *Financial Instruments*, IFRS 10, *Consolidated Financial Statements*, IFRS 12, *Disclosure of Interests in Other Entities*, IFRS 13, *Fair Value Measurement* and amended IAS 27, *Consolidated and Separate Financial Statements*. Each of the new standards and the amendments to IAS 27 and 28 are effective for annual periods beginning on or after January 1, 2013 with early adoption permitted. The amendment to IAS 1, *Presentation of Financial Statements* is however, to be applied to accounting periods beginning on or after July 1, 2012. The Company has not yet begun the process of assessing the impact that the new and amended standards/amendments will have on its financial statements or whether to early adopt any of the new requirements.

The following is a brief summary of the new standards:

#### **IFRS 9 - Financial Instruments - classification and measurement**

IFRS 9 was issued in November 2009. It addresses classification and measurement of financial assets and replaces the multiple category and measurement models in IAS 39, *Financial Instruments – Recognition and Measurement*, for debt instruments with a new mixed measurement model with only two categories: amortized cost and fair value through profit or loss. IFRS 9 also replaces the models for measuring equity instruments and such instruments are either recognized at fair value through profit or loss or at fair value through other comprehensive income. Where such equity instruments are measured at fair value through other comprehensive income, dividends, to the extent not clearly representing a return of investment, are recognized in profit or loss; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely.

Requirements for financial liabilities were added in October 2010 and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss would generally be recorded in other comprehensive income.

IFRS 9 required to be applied for accounting periods beginning on or after January 1, 2013, with earlier adoption permitted.

#### **IFRS 10 – Consolidated Financial Statements**

IFRS 10 requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC-12 *Consolidation—Special Purpose Entities* and parts of IAS 27 *Consolidated and Separate Financial Statements*.

#### **IFRS 12 – Disclosure of Interests in Other Entities**

IFRS 12 establishes disclosure requirements for interests in other entities, such as joint arrangements, associates, special purpose vehicles and off balance sheet vehicles. The standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities.

#### **IFRS 13 - Fair Value Measurement**

IFRS 13 is a comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and in many cases does not reflect a clear measurement basis or consistent disclosures.

#### **Amendments to Other Standards**

An amendment to IAS 1, *Presentation of Financial Statements* was issued in June 2011 and will require companies to group together items within OCI that may be reclassified to profit and loss.

In addition, there have been amendments to existing standards, including IAS 27, *Separate Financial Statements* (IAS 27), and IAS 28, *Investments in Associates and Joint Ventures* (2011). IAS 27 addresses accounting for subsidiaries, jointly controlled entities and associates in non-consolidated financial statements. IAS 28 has been amended to include joint ventures in its scope and to address the changes in IFRS 10 – 13.

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

September 30, 2011 and 2010

(Unaudited; Expressed in US dollars **except where otherwise indicated**)

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### 4. Critical accounting estimates and judgments

The preparation of consolidated financial statements requires the Company's management to make estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, and revenues and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgments about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates. The estimates and assumptions that have a significant risk of causing material adjustments to the Company's financial statements are addressed below.

#### **Mineral reserves and resources**

Mineral reserves and resources are estimates of the quantity of ore that could be economically and legally extracted from a mine. The Company estimates its reserves using information compiled by qualified persons in accordance with the definitions and guidelines adopted by the Canadian Institutes of Mining, Metallurgy and Petroleum. This information relates to geological data on the size, depth and shape of the deposit and requires geological assessments to interpret the data. The assessment of recoverable reserves is based on factors such as the estimated exchange rate, price of metals, capital investments required and production costs stemming from geological assumptions based on the size and grade of the deposit.

Our reserve estimates may have a significant impact on the information contained in our consolidated financial statements. A number of accounting estimates, as described below, are formulated from the reserve estimate.

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

The Company's fair value measurement with respect to the carrying amount of non-financial assets are based on numerous assumptions and may differ significantly from actual fair values.

The fair values are based, in part, on certain factors that may be partially or totally outside of the company's control. This evaluation involves a comparison of the estimated fair values of non-financial assets to their carrying values. The Company's fair value estimates are based on numerous assumptions such as but not limited to estimated realized tungsten prices, operating costs, ore recovery, mineral reserves, capital and site restoration expenditures and estimated future foreign exchanges rates, and may differ from actual fair values and these differences may be significant and could have a material impact on the Company's financial position and result of operations. Mineral reserve estimates are the most important variable in the Company's fair value estimates. A decrease in our reserves may result in an impairment charge, which could reduce the Company's earnings.

Management's estimate of future cash flows is subject to risk and uncertainties. Therefore, it is reasonably possible that changes could occur with evolving economic conditions, which may affect recoverability of the company's non-financial assets.

Assets are reviewed for an indication of impairment at each consolidated balance sheet or consolidated statement of financial position date. This determination requires significant judgment. Factors which could trigger an impairment review include, but are not limited to, significant negative industry or economic trends, and current, historical or projected losses that demonstrate continuing losses.

#### **Depreciation of property, plant and equipment**

A large portion of our property, plant and equipment is depreciated using the units of production method over the expected operating life of the mine based on estimated recoverable reserves and resources, which are the prime determinants of the life of a mine. Estimated recoverable reserves include proven and probable reserves and non-reserved material when sufficient objective evidence exists that it is probable the non-reserve material will be produced. Changes in mineral reserve estimates will result in changes to the depreciation charges over the remaining life of the operation. A decrease in our mineral reserves would increase depreciation expense, and this could have a material impact on our operating results.

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

September 30, 2011 and 2010

(Unaudited; Expressed in US dollars **except where otherwise indicated**)

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### 4. Critical accounting estimates and judgments (cont'd)

#### **Asset retirement obligations**

Asset retirement obligations arise from the development, construction and normal operation of mining property, plant and equipment as mining activities are subject to various laws and regulations governing the protection of the environment. In general, these laws and regulations are continually changing, and we have made, and intend to make in the future, expenditures to comply with such laws and regulations.

We record the estimated present value of reclamation liabilities in the year in which they are incurred. A corresponding increase to the carrying amount of the related asset is recorded and depreciated over the life of the asset. The liability will be increased each year to reflect the interest element and will also be adjusted for changes in the discount rates and in the estimate of the amount, timing and cost of the work to be carried out.

Future remediation costs are accrued based on management's best estimate at the end of each year of the undiscounted cash costs expected to be incurred at each site. Changes in estimates are reflected in earnings in the year during which an estimate is revised. Accounting for reclamation and remediation obligations requires management to make estimates of the future costs they will incur to complete the reclamation and remediation work required to comply with existing laws and regulations. The estimates are dependent on labor costs, known environmental impacts, the effectiveness of remedial and restoration measures, inflation rates and pre-tax interest rates that reflect current market assessment of time value for money and the risk specific to the obligation. The company also estimates the timing of the outlays, which is subject to change depending on continued exploitation and newly discovered mineral reserves.

Actual costs incurred may differ from those estimated amounts. Also, future changes to environmental laws and regulations could increase the extent of reclamation and remediation work required to be performed by the company. Increases in future costs could materially impact the amounts charged to the profit and loss statement for reclamation and remediation.

#### **Share-based remuneration expense**

The estimation of share-based payment costs requires the selection of an appropriate valuation model and consideration as to the inputs necessary for the valuation model chosen. The Company has made estimates as to the volatility of its own shares, the expected life of options, the time of exercise of those options and expected extinguishments. The model used by the Company is the Black-Scholes model.

#### **Provisions and contingent liabilities**

Judgments are made as to whether a past event has led to a liability that should be recognized in the consolidated financial statements or disclosed as a contingent liability. These judgments are based on a number of factors including the nature of the claims or dispute, the legal process and potential amount payable, legal advice received past experience and the probability of a loss being realized. Several of these factors are sources of estimation uncertainty.

#### **Income taxes**

The company is subject to income taxes in numerous jurisdictions. Significant judgment is required in determining the worldwide provision for income taxes. There are transactions and calculations for which the ultimate tax determination is uncertain. The company recognizes liabilities for anticipated tax audit issues based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the current and deferred income tax assets and liabilities in the year in which such determination is made.

Periodically, judgment is required in determining whether deferred tax assets are recognized on the consolidated statement of financial position. Deferred tax assets, including those arising from unused tax losses, require management to assess the probability that the Company will generate taxable profits in future periods, in order to utilize deferred tax assets. Once the evaluation is completed, if we believe that it is probable that some portion our deferred tax assets will fail to be realized, deferred tax asset is derecognized. Estimates of future taxable income are based on forecast cash flows from operations and the application of existing tax laws in each jurisdiction. To the extent that future cash flows and taxable income differ significantly from estimates, the ability of the Company to realize the net deferred tax assets recorded at the reporting date could be impacted.

Additionally, future changes in tax laws in the jurisdictions in which the Company operates could limit its ability to obtain tax deductions in future periods.

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

September 30, 2011 and 2010

(Unaudited; Expressed in US dollars **except where otherwise indicated**)

### 5. Trade and other receivables

	September 30, 2011	December 31, 2010
	\$	\$
Trade receivables	25,362	714,630
Sale taxes receivable	1,109,554	1,104,006
Advances to suppliers	193,806	43,448
Accounts receivable from an associated Company	113,344	151,686
	<u>1,442,066</u>	<u>2,013,770</u>

### 6. Inventories

	September 30, 2011	December 31, 2010
	\$	\$
Finished products	259,323	179,403
Inventory in transit	792,889	1,253,517
	<u>1,052,212</u>	<u>1,432,920</u>
Work in process	21,607	146,506
Supplies	708,368	520,674
	<u>1,782,187</u>	<u>2,100,100</u>

The cost of inventory charged to expense represents all cost of sales and essentially all depreciation and depletion. As at September 30, 2011 and December 31, 2010, there were no write-downs or reversal of write-downs of inventories.

### 7. Investments in Associates

	Three-months ended		Nine-months ended	
	September 30,		September 30,	
	2011	2010	2011	2010
	\$	\$	\$	\$
<i>Dynacor Gold Mines Inc. ("Dynacor")</i>				
Investment at beginning of period	-	1,004,883	-	906,332
Share of net earnings	-	(123,335)	-	(24,784)
Investment at end of period	-	<u>881,548</u>	-	<u>881,548</u>
<i>Hidroeléctrica Pelagatos S.A.C.</i>				
Investment at beginning of period	206,354	-	200,000	-
Purchase of shares		200,000		200,000
Share of net earnings	(6,717)	-	(363)	-
Investment at end of period	<u>199,637</u>	<u>200,000</u>	<u>199,637</u>	<u>200,000</u>

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

September 30, 2011 and 2010

(Unaudited; Expressed in US dollars **except where otherwise indicated**)

### 7. Investments in Associates (cont'd)

#### Investment in Dynacor

As at September 30, 2011, the Company owned 2,884,726 (3,553,426 at December 31, 2010) common shares or 8.1% (10.2% at December 31, 2010) of Dynacor.

Change in status of investment in Dynacor:

Prior to December 17, 2010, the investment in Dynacor was accounted for by the equity method as the Company had the ability to exercise significant influence over Dynacor. Management determined that on December 17, 2010 the status of the investment in Dynacor changed as they lost the ability to exercise significant influence over this investee. The following facts were taken into consideration for their determination of the degree of influence they had over Dynacor:

- (1) on December 17, 2010, the ownership of common shares in Dynacor decreased to 10.2% from 13.5% at December 31, 2009 ;
- (2) the Company is gradually disinvesting of its shares in Dynacor;
- (3) the convertible promissory note was reimbursed;
- (4) representation on the Board of Directors of Dynacor is not sufficient to enable the Company to exercise any significant influence over the policy making process; and
- (5) there are no contracts signed between these two companies that would result in one company being dependent over the other one.

Under IAS 39, the investment was classified as "available-for-sale" and measured at fair value on the consolidated balance sheet, with unrealized gains and losses recognized in other comprehensive income.

### 8. Investments

#### a) Shares in Dynacor

	Three-months ended September 30,		Nine-months ended September 30,	
	2011	2010	2011	2010
	\$	\$	\$	\$
Balance at the beginning of the period	3,188,207	-	4,644,534	-
Sale of shares	(248,733)	-	(874,030)	-
Net change in fair value recorded in other comprehensive income	(1,079,077)	-	(1,910,107)	-
Balance at the end of the period	1,860,397	-	1,860,397	-

For the three and nine months ended September 30, 2011, the Company sold 190,300 shares of Dynacor at an average price of \$1.02 US per share for gross proceeds of \$194,304, and 668,700 shares of Dynacor at an average price of \$1.37 US per share for gross proceeds of \$917,848 respectively.

As at September 30, 2011, the Company owned 2,884,726, (3,553,426 at December 31, 2010) common shares of Dynacor, representing an ownership of approximately 7.7% (9.5% at December 31, 2010) on a fully diluted basis.

#### b) Promissory note

	Three-months ended September 30,		Nine-months ended September 30,	
	2011	2010	2011	2010
	\$	\$	\$	\$
Balance at the beginning of the period	-	2,247,260	-	1,445,783
Net change in fair value recorded in statement of profit and loss	-	188,514	-	992,412
Foreign exchange gain	-	77,748	-	75,327
Balance at the end of the period	-	2,513,522	-	2,513,522

## Malaga Inc.

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### 9. Property plant and equipment

	Mining properties and deferred exploration and development costs \$	Land \$	Buildings \$	Plant & Mining Equipment \$	Vehicles \$	Office equipment \$	Total \$
<b>Cost</b>							
Balance January 1, 2011	10,061,864	633,552	2,187,985	6,309,103	471,680	141,300	19,805,484
Additions	1,395,462	-	30,918	3,831,634	134,552	13,527	5,406,093
<b>Balance September 30, 2011</b>	<b>11,457,326</b>	<b>633,552</b>	<b>2,218,903</b>	<b>10,140,737</b>	<b>606,232</b>	<b>154,827</b>	<b>25,211,577</b>
<b>Accumulated Depreciation and Depletion</b>							
Balance January 1, 2011	6,029,279	-	112,500	507,681	57,299	22,680	6,729,439
Depreciation and Depletion	1,335,815	-	(30,900)	462,560	49,991	19,426	1,836,892
Net allocation to inventory	(65,555)	-	-	-	-	-	(65,555)
<b>Balance September 30, 2011</b>	<b>7,299,539</b>	<b>-</b>	<b>81,600</b>	<b>970,241</b>	<b>107,290</b>	<b>42,106</b>	<b>8,500,776</b>
<b>Net Book Value September 30, 2011</b>	<b>4,157,787</b>	<b>633,552</b>	<b>2,137,303</b>	<b>9,170,496</b>	<b>498,942</b>	<b>112,721</b>	<b>16,710,801</b>
<b>Cost</b>							
Balance January 1, 2010	6,927,317	633,552	2,187,985	4,387,505	444,324	117,516	14,698,199
Additions	1,386,238	-	-	1,921,598	27,356	23,784	3,358,976
Transfers	1,748,309	-	-	-	-	-	1,748,309
<b>Balance December 31, 2010</b>	<b>10,061,864</b>	<b>633,552</b>	<b>2,187,985</b>	<b>6,309,103</b>	<b>471,680</b>	<b>141,300</b>	<b>19,805,484</b>
<b>Accumulated Depreciation and Depletion</b>							
Balance January 1, 2010	3,984,943	-	-	-	-	-	3,984,943
Depreciation and Depletion	2,125,924	-	112,500	507,681	57,299	22,680	2,826,084
Net allocation to inventory	(81,588)	-	-	-	-	-	(81,588)
<b>Balance December 31, 2010</b>	<b>6,029,279</b>	<b>-</b>	<b>112,500</b>	<b>507,681</b>	<b>57,299</b>	<b>22,680</b>	<b>6,729,439</b>
<b>Net Book Value December 31, 2010</b>	<b>4,032,585</b>	<b>633,552</b>	<b>2,075,485</b>	<b>5,801,422</b>	<b>414,381</b>	<b>118,620</b>	<b>13,076,045</b>

For the three and nine month periods ended September 30, 2011, the Company recorded to property, plant and equipment additions pursuant to capital leases obligations in the amount of \$241,219.

## Malaga Inc.

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### 10. Mining properties and deferred development costs

	Huayllapon II	Huaura II	Consuzo	Other	Total
	\$	\$	\$	\$	\$
<b>Mining properties</b>					
Balance January 1, 2011	143,962	524,060	95,289	280,851	1,044,162
Additions	-	-	-	63,401	63,401
Transfers	-	-	-	-	-
<b>Balance September 30, 2011</b>	<b>143,962</b>	<b>524,060</b>	<b>95,289</b>	<b>344,252</b>	<b>1,107,563</b>
<b>Deferred development and exploration costs</b>					
Balance January 1, 2011	757,785	2,712,399	258,539	-	3,728,723
Additions	949,589	45,666	515,378	-	1,510,633
Transfers	-	-	-	-	-
<b>Balance September 30, 2011</b>	<b>1,707,374</b>	<b>2,758,065</b>	<b>773,917</b>	<b>-</b>	<b>5,239,356</b>
<b>TOTAL</b>	<b>1,851,336</b>	<b>3,282,125</b>	<b>869,206</b>	<b>344,252</b>	<b>6,346,919</b>

<b>Mining properties</b>					
Balance January 1, 2010	224,940	831,771	105,876	280,851	1,443,438
Transfers	(80,978)	(307,711)	(10,587)	-	(399,276)
<b>Balance December 31, 2010</b>	<b>143,962</b>	<b>524,060</b>	<b>95,289</b>	<b>280,851</b>	<b>1,044,162</b>
<b>Deferred development and exploration costs</b>					
Balance January 1, 2010	592,878	3,229,531	269,263	-	4,091,672
Additions	351,879	618,002	16,203	-	986,084
Transfers	(186,972)	(1,135,134)	(26,927)	-	(1,349,033)
<b>Balance December 31, 2010</b>	<b>757,785</b>	<b>2,712,399</b>	<b>258,539</b>	<b>-</b>	<b>3,728,723</b>
<b>TOTAL</b>	<b>901,747</b>	<b>3,236,459</b>	<b>353,828</b>	<b>280,851</b>	<b>4,772,885</b>

The Company owns the Pasto Bueno tungsten mine. The Pasto Bueno mine is located in northern Peru, 830 km from the City of Lima. The property consists of 24 concessions for a total of 690 hectares. Certain zones of the Huayllapon II, Huaura II and Consuzo areas were put into commercial operation during 2010. Therefore, the development and exploration costs in the amount of \$1,748,309 were reclassified into development costs in property, plant and equipment.

#### *Projects in Development:*

Exploration work was performed at Huayllapon II, Huaura II and Consuzo areas. The Huayllapon II sector includes the Chabuca, St. Augustin, Paraiso and Limbo veins. The Huaura II sector includes the Alonso Fenix, Santa Marta, Saucó, Violeta, Candela veins as well as the area not in production of the Consuelo vein. The Consuzo sector includes the Loreta and Maria Ofelia veins.

## Malaga Inc.

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### 11. Accounts payable and accrued liabilities

	As at September 30, 2011 \$	As at December 31, 2010 \$
Trade accounts payable and accrued liabilities	1,981,151	2,776,008
Salaries and other	591,896	666,897
	<u>2,573,047</u>	<u>3,442,905</u>

### 12. Long-Term Debt

	As at September 30, 2011 \$	As at December 31, 2010 \$
Advance on future sales payable to customer, without interest, maturing March 31, 2014 (\$1.2M) <sup>1</sup>	810,544	720,535
Loan payable to a customer, without interest, until March 31, 2010 and bearing interest at the 12 month LIBOR rate, maturing March 31, 2014, convertible to a maximum of 19.99% of shares outstanding as of April 1st, 2010 at the holder's option <sup>2</sup>	2,331,609	2,814,433
7.6% unsecured loan from the Peru tax authorities payable in 120 monthly instalments of 2,544 Peruvian Nuevo soles maturing in April 2012	50,403	44,494
Due to former workers and employees of a subsidiary in Peru including interest settlement, with no additional interest, repayable in monthly instalments maturing in 2015 <sup>3</sup>	565,904	715,745
Due to suppliers of a subsidiary in Peru with no interest and no fixed terms of repayment	289,478	270,030
	<u>4,047,938</u>	<u>4,565,237</u>
Less: current portion	1,309,932	1,241,049
	<u>2,738,006</u>	<u>3,324,188</u>

<sup>1</sup> On April 1 2009, the Company entered into a financing agreement whereby it received an advance on sales of \$1.2M, bearing no interest, repayable on the last sales of the sales agreement. This amount has been discounted at an effective rate of 17%, or \$547,392. The difference of \$652,608 between the amount received and the liability was initially recorded as deferred revenue and is recognized as revenue over the shipments expected under the sales agreement.

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

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### 12. Long-Term Debt (cont'd)

<sup>2</sup> In addition, the Company received a loan of \$3.8M initially secured by 3.5 million common shares of Dynacor Gold Mines Inc. which the Company owns (this security was reduced to 1.5 million common shares at December 31, 2010), that is payable in monthly instalments from the thirteenth month after closing the agreement. This loan is convertible at the option of the holder commencing on the twelfth month after closing, and to a maximum of 19.99% of the Company's total common shares outstanding at the market price less a 15% discount. As at September 30, 2011, the outstanding capital balance was \$2.4M (\$3.0M as at December 31, 2010). In accordance with IAS 32, the convertible debt of the Company is a contract with an obligation to issue either cash or a variable number of shares whose value is also variable. The entire instrument is a liability on the grounds that the 'fixed for fixed' requirement in IAS 32 is not met for the instrument as a whole (that is, the instrument is settled in a variable number of shares); the movement in share price determining the number of shares to be delivered under the contract is outside the control of the Company and the holder. In addition, the 15% discount has been assimilated to a premium on debt redemption. The value of the liability component was determined at issuance of the debt. The fair value of the liability component, included in long term debt, was calculated using a market interest rate for an equivalent non-convertible bond.

The amount of the loan has been discounted at an effective rate of 17%, or \$2,988,044. The difference of \$811,956 between the amount received and the liability, was initially recorded as deferred revenue and is recognized as revenue over the expected shipments under the sales agreement.

In addition, the assets of the subsidiary have been pledged as collateral for the loan with the customer. As at September 30, 2011, the book value of assets pledged as security amounted to \$17.1M.

<sup>3</sup> Relative to the acquisition of a Peruvian subsidiary in 2006, the Company had assumed a long term debt regarding amounts due to workers of Peru. This long term debt was included as part of the purchase price allocation. These workers have claimed interest on the outstanding balance. Accordingly, the Company concluded an agreement whereby the new outstanding balance would be 2.5M nuevo soles (\$0.9M) which will not bear any interest. As a result, a non-recurring expense in the amount of \$0.3M was recorded as interest expense in the 2010 fiscal year.

The future capital payments including the impact of the implicit interest over the next five years are as follows:

	\$
2011	383,039
2012	1,200,916
2013	1,054,102
2014	1,455,462
2015	257,235

### 13. Warrants liability

	As at September 30, 2011		As at September 30, 2010	
	Number of warrants	Amount \$	Number of warrants	Amount \$
Balance at the beginning of the period	35,863,333	2,713,995	-	-
Change in fair value		(2,515,828)		-
Foreign Exchange impact		(32,300)		-
Balance at the end of the period	35,863,333	165,867	-	-

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

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(Unaudited; Expressed in US dollars **except where otherwise indicated**)

### 13. Warrants liability (cont'd)

In 2010, as part of the two tranche private placement, the Company issued 35,863,333 ordinary warrants. Each warrant is exercisable at a price of \$0.25 with 34,988,333 ordinary warrants expiring on May 6, 2012 and 875,000 ordinary warrants expiring on June 23, 2012. The ordinary warrants were assigned a value of \$689,150, and were recorded as a derivative liability. At each reporting date they are measured at fair value with the change in fair value recorded in the consolidated statement of comprehensive income until they are exercised at which time they will be transferred to share capital. The ordinary warrants were re-valued at September 30, 2011 using the Black-Scholes valuation model with the following inputs into the model: dividend yield of 0%, credit adjusted risk free interest rate of 1.55%, expected life of 0.92 years, and expected volatility of 81%.

Outstanding ordinary warrants as at September 30, 2011 are as follows:

<u>Expiry Date</u>	<u>Number of Warrants</u>	<u>Exercise Price</u>
May 6, 2012	34,988,333	\$CA 0.25
June 23, 2012	875,000	\$CA 0.25
Total	<u>35,863,333</u>	<u>\$CA 0.25</u>

### 14. Share Capital

#### a) Common Shares Authorized

Unlimited number of common shares, without par value.

Unlimited number of preferred shares, without par value, non-cumulative annual dividend of 8%, redeemable at their issue price, non-participating, non-voting.

#### Issued and fully paid

Movements in the Company's share capital are as follows:

	<u>Nine-months ended September 30, 2011</u>		<u>Nine-months ended September 30, 2010</u>	
	<u>Number of common shares</u>	<u>Amount</u>	<u>Number of common shares</u>	<u>Amount</u>
Balance, beginning of period	183,550,176	39,200,848	147,686,843	35,165,941
Exercise of Stock options <sup>1</sup>	125,000	37,948	-	-
Shares issued <sup>2</sup>	-	-	35,863,333	4,479,372
Share issuance expenses <sup>2</sup>	-	-	-	(442,517)
Balance, end of period	<u>183,675,176</u>	<u>39,238,796</u>	<u>183,550,176</u>	<u>39,202,796</u>

<sup>1</sup> A total of 125,000 stock options were exercised during the nine-month period ended September 30, 2011 under the plan for a cash consideration of \$20,964 (100,000 options at CA\$0.16 and 25,000 options at CA\$0.18). An amount of \$16,984 from the exercise of the stock options was reclassified from contributed surplus to share capital.

<sup>2</sup> During Q2-2010, the Company completed a two tranche private placement of 35,863,333 units at a price of CA\$0.15 per unit for a cash consideration of \$5,198,903. Each unit consists of one common share and one warrant which entitles the holder to purchase one common share at a price of CA\$0.25 with a two year maturity. From the total proceeds received, \$4,479,372 was assigned to share capital, \$689,150 was assigned to the ordinary warrants and \$30,381 was assigned to the broker warrants, according to their respective estimated fair value. Share issuance expenses for this private placement amounted to \$442,517 which includes an amount of \$30,381 as a result of the issuance of 1,405,933 broker warrants. Certain directors and officers and their immediate family purchased 815,000 units for gross proceeds of \$117,458.

## Malaga Inc.

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### 14. Share Capital (cont'd)

#### b) Share Purchase Options

The Company has a stock option plan whereby the Board of Directors, may grant to directors, officers, employees, or consultants of the Company options to acquire common shares. The Board of Directors of the Company has the authority to determine the terms, limits, restrictions and conditions of the grant of options, to interpret the Plan and make all decisions relating thereto. The plan was amended at the annual shareholder's meeting of June 26, 2007 in order to set the maximum number of common shares that may be reserved for issuance to 10,000,000. The maximum number of shares that may be reserved for issuance to any one option holder may not exceed 5% of the common shares outstanding at the time of grant.

The option exercise price is established by the Board of Directors and may not be lower than the market price of the common shares at the time of grant. The options may be exercised during the option period determined by the Board of Directors, which may vary, but will not exceed ten years from the date of the grant. There are 10,000,000 of the Company's common shares which may be issued pursuant to the exercise of share options granted under the Plan. Of this number, 125,000 shares were exercised as at September 30, 2011. As at September 30, 2011, the Company had issued options, allowing for the subscription of 7,520,000 common shares of its share capital.

	Nine-months ended		Nine-months ended	
	September 30, 2011		September 30, 2010	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
	(in '000)	\$CA	(in '000)	\$CA
Balance, beginning of period	8,150	0.29	5,680	0.40
Granted	1,500	0.24	3,600	0.16
Forfeited	(30)	0.32	-	-
Exercised	(125)	0.16	-	-
Expired	(1,975)	0.33	(830)	0.44
Balance, end of period	7,520	0.27	8,450	0.29
Exercisable options	5,707	0.31	5,939	0.34

Outstanding options as at September 30, 2011 are as follows:

Range of exercise prices (\$CA)	Weighted average residual life span (in years)	Outstanding options (in '000)	Weighted average exercise price (\$CA)	Exercisable options (in '000)	Weighted average exercise price (\$CA)
0.14 to 0.18	5.4	3,400	0.16	1,837	0.15
0.23 to 0.33	6.5	2,950	0.26	2,700	0.26
0.50 to 0.69	0.4	700	0.55	700	0.55
0.70 to 0.77	5.7	470	0.77	470	0.77
0.14 to 0.77	5.4	7,520	0.27	5,707	0.31

The following share options were exercised during year:

	Number exercised	Exercise date	Share price at exercise date (\$CA)
Granted on January 11, 2010	100,000	27-May-11	0.285
Granted on June 22, 2001	25,000	20-Jun-11	0.250
	125,000		

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### 14. Share Capital (cont'd)

On May 5, 2011 and June 16, 2011, the Company granted 1,150,000 and 350,000 options respectively to key management and Directors. The weighted average fair value of options granted in 2011 was \$0.18. This estimate was obtained using the Black-Scholes valuation model based on the following inputs:

	<u>June 16, 2011</u>	<u>May 5, 2011</u>
Number of options	350,000	1,150,000
Risk-free interest rate	2.55%	2.55%
Expected life	84 months	84 months
Expected estimated volatility	87%	87%
Dividend yield	nil	nil

For the three and nine month periods ended September 30, 2011, the stock-based compensation charged to the consolidated statement of operations was \$20,038 and \$352,480, respectively (\$45,177 and \$329,936 in Q3-2010). The offsetting credit has been recorded as contributed surplus. The stock based compensation expense was calculated according to the weighted average fair value of options granted based on the Black-Scholes valuation model using the assumptions shown above based on the expected number of options to vest.

### 15. Information Included in the consolidated statement of comprehensive income (loss)

	<u>Three-months ended</u> <u>September 30,</u>		<u>Nine-months ended</u> <u>September 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
	<u>\$</u>	<u>\$</u>	<u>\$</u>	<u>\$</u>
<b>Sales</b>				
Tungsten	4,513,526	3,369,930	13,884,225	9,274,089
Copper	130,451	420,864	1,345,707	1,573,618
	<u>4,643,977</u>	<u>3,790,794</u>	<u>15,229,932</u>	<u>10,847,707</u>
<b>Cost of Sales</b>				
Tungsten	2,403,983	2,433,259	7,355,579	6,903,914
Copper	91,763	232,771	591,602	752,452
Depreciation and depletion of property plant and equipment	562,348	716,518	1,836,892	2,207,632
	<u>3,058,094</u>	<u>3,382,548</u>	<u>9,784,073</u>	<u>9,863,998</u>

## Malaga Inc.

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### 15. Information Included in the consolidated statement of comprehensive income (loss) (cont'd)

#### General and Administration Expenses

	Three-months ended September 30,		Nine-months ended September 30,	
	2011	2010	2011	2010
	\$	\$	\$	\$
Wages and Benefits	450,094	287,019	1,274,416	890,316
Professional Fees	130,574	118,433	543,777	348,533
Investor Relations	114,858	63,125	327,533	173,205
Office Expenses	75,004	110,023	237,700	248,806
Travel Expenses	34,012	52,689	150,159	151,706
Other	28,564	38,496	111,615	158,434
	<u>833,106</u>	<u>669,785</u>	<u>2,645,200</u>	<u>1,971,000</u>
Stock-based compensation	20,038	45,177	352,480	329,936
	<u>853,144</u>	<u>714,962</u>	<u>2,997,680</u>	<u>2,300,936</u>

#### Net finance expenses

	Three-months ended September 30,		Nine-months ended September 30,	
	2011	2010	2011	2010
	\$	\$	\$	\$
Financial expenses	69,456	178,028	183,923	603,789
Accretion expense on long-term debt	129,210	152,411	405,656	460,881
Accretion expense on asset retirement obligation	4,826	4,490	14,387	13,658
Gain on settlement of debt	(53,951)	(58,329)	(165,138)	(117,632)
	<u>149,541</u>	<u>276,600</u>	<u>438,828</u>	<u>960,696</u>

### 16. Earnings per share

#### a. Basic

Basic earnings per common share are calculated by dividing the net income attributable to the owners of the Company by the weighted average number of outstanding common shares in issue during the year.

	Three-months ended September 30,		Nine-months ended September 30,	
	2011	2010	2011	2010
Net income (loss) for the period	1,980,450	(927,698)	4,423,024	(1,643,054)
Weighted average number of common shares outstanding	<u>183,675,176</u>	<u>183,550,176</u>	<u>183,602,923</u>	<u>163,913,619</u>

## Malaga Inc.

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### 16. Earnings per share (cont'd)

#### b. Diluted

Diluted earnings per share is calculated by adjusting the weighted average number of common shares outstanding to assume conversion of all dilutive potential common shares. The Company has three categories of dilutive potential ordinary shares: convertible debt, warrants and share options. The convertible debt is assumed to have been converted into ordinary shares, and the net profit is adjusted to eliminate the interest expense. For the share options and warrants, a calculation is done to determine the number of shares that could have been acquired at fair value (determined as the average annual market share price of the Company's shares) based on the monetary value of the subscription rights attached to outstanding share options and warrants. The number of shares calculated as above is compared with the number of shares that would have been issued assuming the exercise of the share options and warrants.

	Three-months ended September 30,		Nine-months ended September 30,	
	2011	2010	2011	2010
	\$	\$	\$	\$
Net income (loss) for the period	1,980,450	(927,698)	4,423,024	(1,643,054)
Interest expense on debt	82,310	-	261,584	-
Profit used to determine diluted earnings per share	2,062,760	(927,698)	4,684,608	(1,643,054)
Weighted average number of outstanding common shares in issue	183,675,176	183,550,176	183,602,923	163,913,619
Assumed conversion of convertible debt	20,734,349	-	20,734,349	-
Share options	610,000	1,564,750	610,000	1,120,308
Warrants	-	-	-	-
Weighted average number of outstanding shares for diluted earnings per share	205,019,525	185,114,926	204,947,272	165,033,927

### 17. Information Included in the Statements of Cash Flows

	Three-months ended September 30,		Nine-months ended September 30,	
	2011	2010	2011	2010
	\$	\$	\$	\$
<b>Changes in non-cash working capital items</b>				
Accounts receivable	176,758	368,927	574,456	(1,415,683)
Income taxes receivable	30,922	(34,053)	(69,528)	(99,228)
Inventories	37,143	(3,357)	252,358	(635,741)
Prepaid expenses	2,102	232,461	(46,909)	(145,943)
Accounts payable and accrued liabilities	(102,333)	(473,095)	(857,493)	(34,673)
Income taxes payable	-	(46,395)	-	35,786
Unearned revenues	459,624	485,461	453,689	513,572
	604,216	529,949	306,573	(1,781,910)

## Malaga Inc.

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### 18. Transition to IFRS

The Company's consolidated financial statements for the year ending December 31, 2011 will be the first consolidated annual financial statements that comply with IFRS. These condensed interim consolidated financial statements were prepared as described in note 1, including the application of IFRS 1. The effect of the transition to IFRS on consolidated equity, consolidated comprehensive income and the consolidated cash flows is presented and described in this note, and is explained in greater detail in the notes associated with the tables.

IFRS 1 also requires that comparative financial information be provided. As a result, the first date at which the Company has applied IFRS was January 1, 2010 (the "transition date"). IFRS 1 requires first-time adopters to retrospectively apply all effective IFRS standards as of the reporting date, which for the Company will be December 31, 2011. However, it also provides for certain optional exemptions and certain mandatory exceptions for first-time IFRS adopters.

#### **Exceptions and exemptions from full retrospective application elected by the Company**

In preparing these consolidated financial statements in accordance with IFRS 1, the Company has applied mandatory transition exceptions and the following exemptions from full retrospective application of IFRS:

- Fair value as deemed cost : The Company elected to apply the exemption to measure an item of property, plant and equipment at its fair value and use that fair value as its deemed cost going forward as allowed under IFRS 1. As such, the Company re-measured its property, plant and equipment other than mining properties and deferred development cost and exploration and evaluation cost at January 1<sup>st</sup>, 2010 (Note 18 c)).
- IFRS 3(R), *Business Combinations* election: This election allows the Company to adopt IFRS 3(R) prospectively from the date of transition. In accordance with IFRS 1, the Company elected not to apply IFRS 3, *Business Combinations*, (as revised in 2008) to business combinations occurring before January 1, 2010. As such, Canadian GAAP balances relating to business combinations entered into before that date have been carried forward without adjustment.
- Leases election: In accordance with IFRS 1, the Company has elected to apply the transitional provisions in IFRIC 4, *Determining whether an Arrangement contains a Lease*, at the date of transition to all arrangements other than those entered into or modified since January 1, 2005, as such arrangements have already been assessed under requirements similar to those of IFRIC 4. No impact resulted from the review of arrangements.
- The Company has elected to apply the exemption from full retrospective application of decommissioning provisions as allowed under IFRS 1. As such, the Company has re-measured the provisions as at January 1, 2010 under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and estimated the amount to be included in the cost of the related asset by discounting the liability to the date at which the liability first arose. The Company did this using best estimate of the historical risk-adjusted discount rates, and recalculated the accumulated depreciation, depletion and depreciation under IFRS up to the transition date. No transition adjustment was recorded.
- The Company elected under IFRS 1 to apply IFRS 2, *Share-based Payment*, to all equity instruments granted since January 1<sup>st</sup>, 2003.
- The Company elected to apply IAS 23, *Borrowing Costs* prospectively from the date of transition, therefore the accounting of borrowing costs prior to the transition date was not reassessed in the opening IFRS consolidated statement of financial position.
- Reclassification of financial instruments: the Company elected to apply the exemption allowing a change in classification of financial assets/liabilities on first time adoption as allowed under IFRS 1. As such, cash and cash equivalents have been designated as loan and receivable instead as being held-for-trading and the note receivable from Dynacor has been classified as at fair value through profit and loss in accordance with IAS 39. At the date of transition the carrying value under CGAAP approximates the fair value (Note 18 d)).
- The Company elected under IFRS 1 to reset the cumulative translation gains and losses to zero at the transition date.
- Estimates: Hindsight is not used to create or revise estimates. The estimates previously made by the management of the Company under Canadian GAAP were not revised for application of IFRS except where necessary to reflect any difference in accounting policies.

## **Malaga Inc.**

Notes to the condensed interim consolidated financial statements

September 30, 2011 and 2010

(Unaudited; Expressed in US dollars **except where otherwise indicated**)

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### **18. Transition to IFRS (cont'd)**

#### **Reconciliation of IFRS and Canadian GAAP**

IFRS employs a conceptual framework that is similar to Canadian GAAP. However, significant differences exist in certain matters of recognition, measurement and disclosure. While adoption of IFRS has not changed the Company's actual cash flows, it has resulted in changes to the Company's reported financial position and income statement. In order to allow the users of the condensed interim consolidated financial statements to better understand these changes, the Company's Canadian GAAP consolidated statements of operations and comprehensive loss for the three and nine-month periods ended September 30, 2010 as well as the statements of financial position as at September 30, 2010 have been reconciled to IFRS, with the resulting differences explained.

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

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### 18. Transition to IFRS (cont'd)

The September 30, 2010 Canadian GAAP consolidated statement of financial position has been reconciled to IFRS as follows:

Note	CDN GAAP (CA\$)	CDN GAAP (US\$) (a)	Functional Currency Adjustment (b)	IFRS Adjustments	IFRS (US\$)
<b>Assets</b>					
<b>Current assets</b>					
Cash	948,325	921,599	-	-	921,599
Trade and other receivables	2,660,615	2,585,632	-	-	2,585,632
Income tax installments receivable	805,386	782,688	-	-	782,688
Inventories	1,864,440	1,811,895	(8,064)	-	1,803,831
Prepaid expenses	328,566	319,306	-	-	319,306
	<u>6,607,332</u>	<u>6,421,120</u>	<u>(8,064)</u>	<u>-</u>	<u>6,413,056</u>
<b>Non-current assets</b>					
Investment in associates (d2)	2,799,708	2,720,805	25,004	(1,664,261)	1,081,548
Other long-term investments (d1)	-	-	-	2,513,522	2,513,522
Property, plant and equipment (c)	10,274,369	9,984,810	(419,420)	3,081,223	12,646,613
Mining properties and deferred development and exploration costs	4,846,425	4,709,840	(238,112)	-	4,471,728
	<u>17,920,502</u>	<u>17,415,455</u>	<u>(632,528)</u>	<u>3,930,484</u>	<u>20,713,411</u>
<b>Total assets</b>	<u>24,527,834</u>	<u>23,836,575</u>	<u>(640,592)</u>	<u>3,930,484</u>	<u>27,126,467</u>
<b>Liabilities</b>					
<b>Current liabilities</b>					
Accounts payable and accrued liabilities	4,052,478	3,938,268	-	-	3,938,268
Income tax payable	80,108	77,850	-	-	77,850
Unearned revenues	723,364	702,978	-	-	702,978
Current portion of long-term debt (f1)	1,337,085	1,299,402	-	-	1,299,402
Current portion of finance lease liabilities	169,493	164,716	-	-	164,716
	<u>6,362,528</u>	<u>6,183,214</u>	<u>-</u>	<u>-</u>	<u>6,183,214</u>
<b>Non-current liabilities</b>					
Long-term debt (f1)	3,000,399	2,915,840	-	647,720	3,563,560
Finance lease liabilities	88,338	85,848	-	-	85,848
Warrants liability (e)	-	-	-	1,201,733	1,201,733
Deferred revenues (f2)	1,392,454	1,353,211	-	(312,006)	1,041,205
Asset retirement obligation	594,013	577,272	(11,870)	(988)	564,414
	<u>5,075,204</u>	<u>4,932,171</u>	<u>(11,870)</u>	<u>1,536,459</u>	<u>6,456,760</u>
<b>Shareholders' equity</b>					
Share capital	43,740,344	39,202,796	-	-	39,202,796
Warrants (e)	748,888	719,531	-	(689,150)	30,381
Contributed surplus	3,881,725	3,507,692	-	-	3,507,692
Conversion option (f3)	319,903	270,050	-	(270,050)	-
Cumulative Translation Adjustment	-	1,104,182	(628,722)	(475,460)	-
Deficit (g)	(35,600,758)	(32,083,061)	-	3,828,685	(28,254,376)
<b>Total equity</b>	<u>13,090,102</u>	<u>12,721,190</u>	<u>(628,722)</u>	<u>2,394,025</u>	<u>14,486,493</u>
<b>Total liabilities and equity</b>	<u>24,527,834</u>	<u>23,836,575</u>	<u>(640,592)</u>	<u>3,930,484</u>	<u>27,126,467</u>

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

September 30, 2011 and 2010

(Unaudited; Expressed in US dollars **except where otherwise indicated**)

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### 18. Transition to IFRS (cont'd)

**Explanatory notes of material adjustments arising from the adoption of IFRS and significant differences in accounting policy between Canadian GAAP and IFRS applicable to the Company:**

#### a) Presentation currency

In conjunction to the transition to IFRS, the Company elected to change its presentation currency from Canadian to United States dollar in order that the financial statements more accurately reflect the Company's true operating results and financial position since a majority of the Company's business is conducted in US dollar. Accordingly, the Canadian GAAP financial information previously expressed in Canadian dollars has been presented in U.S. dollars for all periods shown, using the exchange rate applicable at the balance sheet date for assets and liabilities, and the average exchange rate of the corresponding periods for the consolidated statements of income and consolidated statements of cash flows items. Equity transactions have been translated at historical rates for the last three fiscal years with opening equity on April 1, 2007, translated at the exchange rate on that date. The net adjustment arising from the effect of the translation was included in the cumulative translation adjustment account in shareholders' equity.

#### b) Functional currency

Under IFRS, the framework used to determine the functional currency is similar to that used to determine the currency of measurement under Canadian GAAP; however, under IAS 21, *The Effects of Changes in Foreign Exchange Rates*, the indicators for determining the functional currency are broken down into primary and secondary indicators when determining the functional currency. Primary indicators are closely linked to the primary economic environment in which the entity operates and are given more weight. Secondary indicators provide supporting evidence to determine an entity's functional currency. Primary indicators receive more weight under IFRS than Canadian GAAP. As a result of this difference, management has concluded that the most appropriate functional currency of the parent company and substantially all of its subsidiaries and associates is the US dollar. Historically, the currency of measurement of the company was the Canadian dollar and all subsidiaries and the most significant associates were considered integrated and accordingly, their currency of measurement was the Canadian dollar.

Accordingly, all non-monetary assets and liabilities have been converted at their respective historical dates. In addition, in accordance with IFRS 1, the company has elected to reset the cumulative translation adjustment account, which includes gains and losses arising from the translation of foreign operations and the effects of the different functional currency described above, to zero at the date of transition to IFRS.

#### c) Property, plant and equipment

	<b>As at September 30, 2010</b>
Canadian GAAP CA\$	10,274,369
Effect of change in Presentation Currency	(289,559)
Canadian GAAP US\$	9,984,810
Impact of Measuring opening balance at Fair Value	2,483,882
Cumulative Effect of Depreciation and Depletion	597,341
Effect of Change in Functional Currency	(419,420)
IFRS US\$	12,646,613

## Malaga Inc.

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### 18. Transition to IFRS (cont'd)

#### c) Property, plant and equipment (cont'd)

The Company elected to apply the exemption to measure an item of property, plant and equipment at its fair value and use that fair value as its deemed cost going forward as allowed under IFRS 1. As such, the Company re-measured its property, plant and equipment other than mining properties and deferred development cost and exploration and evaluation cost. In conjunction with the re-measurement of the property, plant and equipment at fair value, the component parts of these assets have also been reassessed, having a direct impact on the depreciation expense.

The adjustment at the transition date, amounts to \$2,483,882, has been recognized in property, plant and equipment with the corresponding adjustment in opening deficit. The aggregate fair value of those re-valued items amounts to \$7,737,920 as at January 1st 2010.

#### d) Investments

##### 1) Promissory note

	<b>As at September 30, 2010</b>
Canadian GAAP CA\$	1,519,518
Effect of Change in Presentation Currency	(42,824)
Canadian GAAP US\$	1,476,694
Impact of Measuring at Fair Value	992,412
Effect of Change in Functional Currency	44,416
IFRS US\$	2,513,522

Under IFRS, the promissory note is a financial instrument designated at fair value through profit and loss financial asset, which must be measured at fair value due to the significant embedded derivative under the form of a written put option. The fair value of the promissory note is based on the fair value of the underlying common shares of Dynacor. Accordingly, this promissory note is classified as a level 2 financial instrument according to the fair value hierarchy as it is based on observable market data. The promissory note was classified as an investment in associate under CGAAP and as an investment under IFRS.

##### 2) Shares in Dynacor

	<b>As at September 30, 2010<sup>1</sup></b>
Canadian GAAP CA\$	1,074,424
Effect of Change in Presentation Currency	(30,280)
Canadian GAAP US\$	1,044,144
Cumulative Effect of Share in Earnings	(143,151)
Effect of Change in Functional Currency	(19,445)
IFRS US\$	881,548

<sup>1</sup> Investment in associate

## Malaga Inc.

Notes to the condensed interim consolidated financial statements

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(Unaudited; Expressed in US dollars **except where otherwise indicated**)

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### 18. Transition to IFRS (cont'd)

#### d) Investments (cont'd)

Under IFRS, when an investor loses significant influence over an associate, the retained investment shall be measured at its fair value. Any difference between the fair value of the retained investment and the carrying amount of the investment at the date when significant influence is lost shall be recognized in the statement of profit and loss as opposed to other comprehensive income in CGAAP. Accordingly, as at December 31, 2010, this investment is classified as a level 2 financial instrument according to our fair value hierarchy as it is based on observable market data.

Consequently, the Company is exposed to equity price risk because of its investment held and classified on the consolidated statement of financial position as available-for-sale. Equity price risk is the risk that the fair value of a financial instrument varies due to equity market changes.

#### e) Warrants

	<b>As at September 30, 2010</b>
Per Canadian GAAP CA\$	717,267
Effect of Change in Presentation Currency	(28,117)
Canadian GAAP US\$	<u>689,150</u>
Effect of measurement at fair value	504,680
Foreign Exchange Impact	<u>7,903</u>
IFRS US\$	<u>1,201,733</u>

The Company has issued warrants that entitle the holder to acquire a fixed number of common shares for a fixed Canadian dollar price per share. In accordance with IFRS, an obligation to issue shares for a price that is not fixed in the Company's functional currency, and that does not qualify as a rights offering to all shareholders of that class, must be classified as a derivative liability and measured at fair value with changes recognized in the consolidated statement of comprehensive income (loss) as they arise. The Company has recorded these charges in 'Gain/loss on revaluation of financial instruments'.

Under Canadian GAAP, the warrants were classified as equity and changes in fair value were not recognized. This change in accounting increased (decrease) liabilities and reduced (increased) "Gain/loss on revaluation of financial instruments". Accordingly, those warrants were classified as a level 3 financial instrument according to our fair value hierarchy as it is based on significant non-observable market data.

Consequently, the Company is exposed to valuation risk because of its warrants held and classified on the consolidated balance sheet as fair value through profit and loss. Equity price risk is the risk that the fair value of a financial instrument varies due to equity market changes.

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Notes to the condensed interim consolidated financial statements

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### 18. Transition to IFRS (cont'd)

#### f) Loan payable to a customer

##### 1) Long term Debt

	<b>As at September 30, 2010</b>
Per Canadian GAAP CA\$	4,337,484
Change in Presentation Currency	(122,242)
Per Canadian GAAP US\$	4,215,242
IFRS Adjustment	732,221
Cumulative effect of accretion under IFRS	(84,501)
IFRS US\$	4,862,962

##### 2) Deferred Revenues

	<b>As at September 30, 2010</b>
Per Canadian GAAP CA\$	1,392,454
Change in Presentation Currency	(39,243)
Per Canadian GAAP US\$	1,353,211
IFRS Adjustment	(378,867)
Cumulative effect of amortization	66,861
IFRS US\$	1,041,205

##### 3) Conversion Option

	<b>As at September 30, 2010</b>
Per Canadian GAAP CA\$	319,903
Change in Presentation Currency	(49,853)
Per Canadian GAAP US\$	270,050
IFRS Adjustment	(270,050)
IFRS US\$	-

This loan is convertible at the option of the holder to a maximum of 19.99% of the Company's total common shares outstanding at the market price less a 15% discount.

In accordance with IAS 32, the convertible debt of the Company is a contract with an obligation to issue either cash or a variable number of shares whose value is also variable. The entire instrument is a liability on the grounds that the 'fixed for fixed' requirement in IAS 32 is not met for the instrument as a whole (that is, the instrument is settled in a variable number of shares).

Accordingly, there is no conversion option recognized in equity under IFRS. Furthermore, the fair value of the debt at initial recognition has been remeasured by assimilating the 15% discount to a premium on debt redemption. The corresponding adjustments have been recorded in deferred revenues and retained earnings.

## Malaga Inc.

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### 18. Transition to IFRS (cont'd)

#### g) Deficit

	<b>As at September 30, 2010</b>
Per Canadian GAAP CA\$	(35,600,758)
Change in Presentation Currency	4,621,879
Per Canadian GAAP US\$	(30,978,879)
Impact of Measuring property plant and equipment at Fair Value	3,081,223
Impact of Loan From Customer	(65,664)
Impact of measuring Warrants at fair Value	(512,583)
Change in Fair Value Promissory note	992,412
Change in share in earnings	(143,151)
Change in accretion on asset retirement obligation	988
Functional Currency	(628,722)
IFRS US\$	(28,254,376)

#### IFRS adjustments to the consolidated statement of comprehensive income

#### h) Comprehensive income for the period

Three months ended September 30, 2010	Net income (loss)	Other comprehensive income (loss)	Comprehensive income (loss)
Per Canadian GAAP CA\$	(619,667)	-	(619,667)
Change in presentation currency	23,547	-	23,547
Per Canadian GAAP US\$	(596,120)	-	(596,120)
Difference in Depletion and Depreciation	210,910	-	210,910
Amortization of deferred revenues	(22,287)	-	(22,287)
Net impact of accretion and gain on settlement of long term debt	48,088	-	48,088
Change in fair value of Promissory note	188,514	-	188,514
Equity pick-up	(151,240)	-	(151,240)
Accretion of asset retirement obligation	(500)	-	(500)
Fair value variation on warrants	(504,680)	-	(504,680)
Foreign exchange gain on warrants	(23,310)	-	(23,310)
	(850,625)	-	(850,625)
Change in functional Currency	(77,073)	-	(77,073)
IFRS US\$	(927,698)	-	(927,698)

## Malaga Inc.

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### 18. Transition to IFRS (cont'd)

#### IFRS adjustments to the consolidated statement of comprehensive income

##### i) Comprehensive income for the period

	Net income (loss)	Other comprehensive income (loss)	Comprehensive income (loss)
Nine months ended September 30, 2010			
Per Canadian GAAP CA\$	(2,712,044)	-	(2,712,044)
Change in presentation currency	88,777	-	88,777
Per Canadian GAAP US\$	(2,623,267)	-	(2,623,267)
Difference in Depletion and Depreciation	597,341	-	597,341
Amortization of deferred revenues	(66,861)	-	(66,861)
Net impact of accretion and gain on settlement of long term debt	84,501	-	84,501
Change in fair value of Promissory note	992,412	-	992,412
Equity pick-up	(143,151)	-	(143,151)
Accretion of asset retirement obligation	988	-	988
Fair value variation on warrants	(504,680)	-	(504,680)
Foreign exchange gain on warrants	(7,903)	-	(7,903)
	(1,670,620)	-	(1,670,620)
Change in functional Currency	27,566	-	27,566
IFRS US\$	(1,643,054)	-	(1,643,054)

##### j) General and administration expenses

	Three-months ended September 30, 2010	Nine-months ended September 30, 2010
Per Canadian GAAP CA\$	695,952	2,040,318
Change in presentation currency	(26,167)	(69,318)
Per Canadian GAAP US\$	669,785	1,971,000
Stock-based compensation	45,177	329,936
IFRS US\$	714,962	2,300,936

For IFRS purposes, stock-based compensation is presented under general and administrative expenses.

##### k) Finance expense

	Three-months ended September 30, 2010	Nine-months ended September 30, 2010
Canadian GAAP, as reported	-	-
Interest and banking fees	178,028	603,789
Accretion expense of long term debt	152,411	460,881
Gain on debt settlement	(58,329)	(117,632)
Accretion expense of asset retirement obligation	4,490	13,658
IFRS basis	276,600	960,696

For IFRS purposes, accretion expenses are combined with interest expense and are presented as Finance expenses on the consolidated statement of comprehensive income.

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### **18. Transition to IFRS (cont'd)**

#### **l) Comparative Figures**

Certain Canadian GAAP comparative figures have been reclassified to conform to the financial presentation adopted at December 31, 2010.

#### **Adjustments to the consolidated statement of cash flows**

The transition from Canadian GAAP to IFRS had no significant impact on cash flows generated by the Company.

### **19. Events after the Reporting Period**

The Company has subsequently entered into an agreement whereby its customer has agreed to make an advance payment of \$800,000, repayable on or before February 28, 2012.

In addition, on November 11, 2011, the Company agreed to terms on a bridge financing loan in the amount of CA \$1,000,000 (USD \$982,500) bearing a 12% annual rate of interest payable quarterly and a premium of CA\$ 60,000 (USD \$ 59,000) payable November 30, 2012, which is contingent on EBITDA (earnings before interest, taxes, depreciation and amortization) exceeding USD \$5,400,000 for a 12 month period beginning October 1, 2011 through September 30, 2012. The issuance of the loan is expected to close by the end of November with a maturity date of November 30, 2012. The loan will be secured by 1,000, 000 common shares of the Company's available for sale investment of Dynacor (refer to note 8a).