

Malaga Inc.

Consolidated Financial Statements

Years ended December 31, 2009 and 2008



PricewaterhouseCoopers
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Auditors' Report

To the Shareholders of Malaga Inc.

We have audited the consolidated balance sheets of **Malaga Inc.** as at December 31, 2009 and 2008 and the consolidated statements of operations, comprehensive loss and deficit, and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Montreal, Canada
March 30, 2010

1 Chartered accountant auditor permit No. 14707

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Malaga inc.

Consolidated Balance Sheets as at December 31

	2009	2008
	\$	\$
ASSETS		
CURRENT ASSETS		
Cash on hand	1,149,101	-
Short-term investments (Note 4)	-	800,000
Accounts receivable (Note 5)	1,511,942	2,100,552
Income taxes receivable	695,432	674,695
Inventories (Note 6)	1,369,423	1,459,409
Prepaid expenses	182,204	97,402
	<u>4,908,102</u>	<u>5,132,058</u>
Investments (Note 7)	2,471,942	4,847,645
Property, plant and equipment (Note 8)	8,801,346	8,751,905
Mining properties and deferred development and exploration expenses (Note 9)	6,034,270	5,294,282
	<u>22,215,660</u>	<u>24,025,890</u>
LIABILITIES		
CURRENT LIABILITIES		
Bank overdraft	-	43,964
Bank loans (Note 10)	-	876,592
Accounts payable and accrued liabilities (Note 11)	5,237,667	5,176,805
Income taxes payable	45,996	139,093
Unearned revenues	199,065	-
Current portion of long-term debt (Note 12)	774,637	13,899
Current portion of obligations under capital leases (Note 13)	264,030	277,337
	<u>6,521,395</u>	<u>6,527,690</u>
Long-term debt (Note 12)	2,674,845	163,469
Deferred revenues (Note 12)	1,726,994	-
Obligations under capital leases (Note 13)	206,744	257,492
Asset retirement obligations (Note 14)	578,845	498,845
	<u>11,708,823</u>	<u>7,447,496</u>
SHAREHOLDERS' EQUITY		
Share capital (Note 15)	39,536,003	38,445,305
Contributed surplus (Note 16)	3,539,644	3,386,533
Conversion option (Note 12)	319,903	-
Deficit	(32,888,713)	(25,253,444)
	<u>10,506,837</u>	<u>16,578,394</u>
	<u>22,215,660</u>	<u>24,025,890</u>

Going concern assumption (Note 1)

Contingencies (Note 22)

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 the consolidated financial statements.

Malaga inc.

Consolidated Statements of Earnings, comprehensive loss and deficit for the years ended December 31

	2009	2008
	\$	\$
Sales	11,177,720	10,621,527
Cost of sales (excluding amortization and depletion)	(9,575,834)	(8,534,955)
Amortization and depletion	(4,087,901)	(1,903,743)
Accretion expense of asset retirement obligations (Note 14)	(80,000)	(75,086)
Income (loss) from mining activities	(2,566,015)	107,743
General and administrative expenses	(2,605,539)	(2,784,328)
Stock-based compensation (Note 15c)	(153,111)	(270,975)
Operating loss	(5,324,665)	(2,947,560)
Interest	(395,965)	(338,348)
Accretion expense of long-term debt	(320,811)	-
Gain on sale of property, plant and equipment	25,142	115,165
Foreign exchange gain (loss)	756,733	(168,069)
Loss before undernoted	(5,259,566)	(3,338,812)
Share of earnings (loss) in investment using equity method	(871,371)	210,214
Impairment in investment value (Note 7)	(1,504,332)	-
Loss and comprehensive loss	(7,635,269)	(3,128,598)
Loss per share	(0.05)	(0.02)
Weighted average number of outstanding common shares	140,770,271	137,117,367
Deficit, beginning of year	(25,253,444)	(22,124,846)
Loss for the year	(7,635,269)	(3,128,598)
Deficit, end of year	(32,888,713)	(25,253,444)

Going concern assumption (Note 1)
Contingencies (Note 22)

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

Malaga inc.

Consolidated Statements of Cash Flows for the years ended December 31

	2009	2008
	\$	\$
Operating activities		
Net loss	(7,635,269)	(3,128,598)
Items not affecting cash and cash equivalents		
Amortization and depletion	4,087,901	1,903,743
Amortization of deferred revenues	(278,767)	-
Accretion expense of asset retirement obligation (Note 14)	80,000	75,086
Accretion expense of long-term debt	320,811	-
Stock-based compensation (Note 15b)	153,111	270,975
Gain on sale of property, plant and equipment	(25,142)	(115,165)
Share of earnings (loss) in investments using equity method	871,371	(210,214)
Impairment in investment value (Note 7)	1,504,332	-
Unrealized foreign exchange loss (gain)	(966,126)	661,545
	<u>(1,887,778)</u>	<u>(542,628)</u>
Change in non-cash working capital items (Note 18)	1,209,405	1,382,702
	<u>(678,373)</u>	<u>840,074</u>
Investing activities		
Short-term investments	800,000	2,763,053
Proceeds from sale of property, plant and equipment	253,193	59,622
Acquisition of property, plant and equipment	(2,803,740)	(1,312,189)
Addition to mining properties and deferred development and exploration expenses	(2,289,027)	(3,301,950)
	<u>(4,039,574)</u>	<u>(1,791,464)</u>
Financing activities		
Proceeds of bank loans	2,441,427	2,108,487
Repayments of bank loans	(3,318,019)	(1,598,868)
Proceeds of long-term debt	6,018,670	-
Repayment of long term debt	(10,849)	(8,199)
Obligations under capital leases	(310,915)	(191,195)
Issuance of shares	1,150,698	-
Share issuance expenses	(60,000)	-
Proceeds from an affiliated company	-	450,913
Repayment of advances from an affiliated company	-	(234,012)
	<u>5,911,012</u>	<u>527,126</u>
Change in cash and cash equivalents	1,193,065	(424,264)
Cash on hand (bank overdraft), beginning of year	(43,964)	380,300
Cash on hand (bank overdraft), end of year	<u>1,149,101</u>	<u>(43,964)</u>

Going concern assumption (Note 1)

Contingencies (Note 22)

Additional information on cash flows (Note 18)

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

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

1. Statute of Incorporation, Nature of Activities and Going Concern

Malaga Inc. ("Malaga" or the "Company"), is incorporated under Part 1A of the Companies Act (Québec), as a mining company having its activities in Peru. The Company operates mainly in Peru at its tungsten mine in Pasto Bueno.

The Company also has 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.

The Company has incurred operating losses over the past few fiscal years, has limited financial resources and operating cash flow, and there is no assurance that sufficient funding, including adequate financing, will be available to satisfy working capital requirements. The Company's cash flow has been adversely affected by the higher cost of production and lower sales prices and it is expected that cash on hand at December 31, 2009, will not be sufficient to fund the Company's ongoing activities. Although there is no assurance the Company will be successful in securing sufficient financing, management will strive to do so through various means including issuing shares, borrowing funds and selling a part of its investment in Dynacor Gold Mines Inc.

These consolidated financial statements have been prepared according to Canadian generally accepted accounting principles and on a going concern basis. The application of generally accepted accounting principles on a going concern basis may be inappropriate, since there is a significant doubt as to the validity of the going concern assumption.

These financial statements do not reflect the adjustments that should be made to the carrying values of assets and liabilities, the reported amounts of revenues and expenses and the classification of balance sheet items should the going concern assumption be inappropriate, and these adjustments could be material. Management did not take these adjustments into account as it believes in the validity of the going concern assumption.

2. Significant accounting policies

Basis of consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries, Dynacor Exploraciones del Perú S.A.C. (100%), Minera Pasto Bueno S.A.C. (100%), and Minera Malaga Santolalla S.A.C. (100%).

Investments in Hidroeléctrica Pelagatos S.A.C. and Dynacor Gold Mines Inc.

The investments in Hidroeléctrica Pelagatos S.A.C. (44%) and Dynacor Gold Mines Inc. (13.5%) for which they exercise significant influence, are accounted for using the equity method. According to this method, the investments are recorded at cost to which is added the company's share in the net income of the company and from which are deducted the company's share in the net losses of the company and dividends paid by the company.

Malaga Inc.

Notes to consolidated financial statements
December 31, 2009 and 2008

2. Significant accounting policies (cont'd)

Use of estimates

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires the Company's management to make estimates and assumptions that affect the reported amounts of assets and liabilities shown on the consolidated balance sheet, the contingency mentioned at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period.

The significant estimates in connection with these consolidated financial statements are those related to the useful life and residual value of property, plant and equipment, the recoverable value of mining properties and deferred development and exploration expenses, the assessment of reserves and resources, stock-based compensation, warrants, contingent liabilities, the asset retirement obligation for property, plant and equipment and the impairment in the value of investments. Actual results could differ from these estimates.

Revenue recognition

Revenue is recorded when convincing evidence of an arrangement exists, delivery has occurred under the terms of the arrangement and these are no longer under the physical control of the Company, the price is fixed or determinable and collection is reasonably assured.

Cash and cash equivalents

Cash and cash equivalents are classified as held for trading and are valued at their fair market value. Cash and cash equivalents include cash on hand, bank overdraft and short-term investments with original maturities at the date of purchase of 90 days or less.

Inventories

Finished goods, concentrate in process at the plant, stockpiled ore and the assets for resale are valued at the lower of average production cost and estimated net realizable value. Supplies are valued at the lower of average cost and replacement cost.

Property, plant and equipment

Property, plant and equipment including the assets under a capital lease are accounted for at cost. Amortization is based on their estimated life using the diminishing balance method at the following annual rates:

	Rates
Building	5%
Vehicles	25%
Plant and mining equipment	30%
Office equipment	30%

The development costs are amortized using the units of production method based on the proven and probable reserves and the non-reserve resources when sufficient objective evidence exists to support the conclusion that it is probable that the non-reserve resources will be produced.

Mining properties and deferred development and exploration expenses

Each property is accounted for as a separate project. Costs related to the acquisition, exploration and development of non-producing mining properties are capitalized by property until the beginning of commercial production. When commercially profitable ore reserves are developed, related capitalized costs are reclassified to property, plant and equipment as mining assets and amortized using the units of production method.

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

2. Significant accounting policies (cont'd)

Mining properties and deferred development and exploration expenses (cont'd)

The mining assets are tested for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable, which is determined by comparing the asset's book value with estimated future undiscounted cash flows for expected use and for eventual disposal of the assets. The impairment loss represents the excess carrying value over the fair value, which is mainly calculated by discounting estimated future cash flows to be derived from the use and eventual disposal of the assets. If the Company does not have sufficient information on its mining assets to estimate the estimated cash flows to review the recoverability of capitalized costs, the Company determines impairment by comparing the fair value to book value, without first making a recoverability test. Costs not related to specific properties are accounted for in the consolidated statement of earnings.

The recoverability of amounts recorded for non-producing mining properties and deferred exploration expenses is dependent upon the discovery of economically recoverable reserves, the confirmation of the Company's interest in the mining properties, the ability of the Company to obtain the necessary financing to complete the development, and future profitable production or proceeds from the disposition thereof.

The amortization of property, plant and equipment during the exploration and development period up to the production period is capitalized in deferred exploration expenses.

The net proceeds from the sale of ore extracted from mining properties, obtained during the exploration and development period and prior to achieving commercial production levels, are recorded as a reduction to the related deferred exploration expenses.

Investments

Investments, over which the Company exerts significant influence, are accounted for using the equity method. Under this method, the Company's share of the earnings and losses is included in operations and the investment therein is adjusted by a like amount. When in management's opinion there has been a loss in value that is other than a temporary decline, the carrying value is reduced to estimated realizable value.

Impairment of long-lived assets

The Company monitors events and changes in circumstances, which may require an assessment of the recoverability of its long-lived assets. The Company assesses recoverability using estimated undiscounted future cash flows from its use and residual value. If it is determined that the net recoverable amount of a long-lived asset is less than the carrying amount, determined according to the discounted future cash flows, long-lived assets are written down to the net recoverable amount and a corresponding impairment loss is recorded on the statement of earnings.

Management's estimate of future cash flows is subject to risks and uncertainties. Therefore, it is reasonably possible that changes could occur which may affect the recoverability of the Company's property, plant and equipment.

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

2. Significant accounting policies (cont'd)

Foreign currency translation and integrated foreign subsidiaries

The accounts of the Company's integrated subsidiaries and balances denominated in foreign currencies are translated using the temporal method.

This method translates foreign currency monetary assets and liabilities into Canadian dollars at the rate of exchange at the consolidated balance sheet dates, non-monetary balances at historical exchange rates and revenue and expense items at transaction dates. The resulting gains and losses are included in the consolidated statements of earnings.

Financial instruments

All transactions related to financial instruments are recorded on a trade date basis.

Financial instruments (cont'd)

The Company uses different financial instruments. The Company classifies its financial instruments into one of the following categories based on the purpose for which the asset was acquired. The Company's accounting policy for each category is as follows:

Held-for-trading

This category is comprised of certain investments in equity and debt instruments, stand-alone derivatives, other than those designated as hedging items, and embedded derivatives requiring separation. They are carried in the balance sheet at fair value with changes in fair value recognized in the consolidated statement of earnings.

Loans and receivables

These assets are non-derivative financial assets resulting from the delivery of cash or other assets by a lender to a borrower in return for a promise to repay on specified dates, or on demand. They arise principally through the provision of goods and services to customers, but also incorporate other types of contractual monetary assets. They are initially recognized at fair value and subsequently carried at amortized cost, using the effective interest rate method, less any provision for impairment recorded on the consolidated statement of earnings.

Held-to-maturity investments

These assets are non-derivative financial assets with fixed or determinable payments and fixed maturities that the company's management has the positive intention and ability to hold to maturity. These assets are initially recognized at fair value and subsequently carried at amortized cost, using the effective interest rate method, less any provision for impairment recorded on the consolidated statement of earnings.

Other financial liabilities

Other financial liabilities include all financial liabilities other than those classified as held-for-trading and comprises bank loans, accounts payable and long-term debt. These liabilities are initially recognized at fair value and subsequently carried at amortized cost using the effective interest rate method.

The Company classified financial instruments as follows:

- Cash on hand classified as held-for-trading
- Short-term investments classified as held-for-trading
- Trade accounts receivable, advances and other receivables classified as loans and receivables
- Bank loans, accounts payable and long term debts classified as other liabilities.

Malaga Inc.

Notes to consolidated financial statements
December 31, 2009 and 2008

2. Significant Accounting Policies (cont'd)

Income Taxes

The Company provides for income taxes using the liability method of tax allocation. Under this method, future income tax assets and liabilities are determined based on deductible or taxable temporary differences between financial statement values and tax values of assets and liabilities using enacted income tax rates expected to be in effect for the year in which the differences are expected to reverse.

The Company establishes a valuation allowance against future income tax assets if, based upon available information, it is more likely than not that some or all of the income tax assets will not be realized.

Share Issuance Expenses

The share capital is presented net of share issuance expenses.

Earnings Per Share

Earnings per share are calculated using the weighted average number of shares outstanding during the period. Diluted earnings per share reflect the potential dilution of common share equivalents, such as outstanding stock options and warrants, in the weighted average number of common shares outstanding during the period, if dilutive.

In the case of a loss, the diluted earnings per share is equal to the basic earnings per share due to the anti-dilutive effect of the stock options and the warrants.

Asset Retirement Obligations

The total amount of the estimated cash flow required to settle the obligations arising from environmentally acceptable closure and post-closure plans is discounted based on the Company's credit-adjusted risk-free rate and is recorded as a liability. The counterpart of these obligations is capitalized to property, plant and equipment. The asset retirement obligations recorded are adjusted for accumulated accretion in accordance with the expected timing of cash flow payments required to settle these obligations.

Stock-based Compensation Plan

The Company has a stock-based compensation plan, which is described in Note 15. The Company accounts for all stock-based compensation using the fair value method. This method consists of recording expenses to earnings based on the vesting of the options granted and the counterpart is accounted for in contributed surplus on the balance sheet. The fair value is calculated based on the Black-Scholes valuation model. When stock options are exercised, any consideration paid is credited to share capital.

3. Changes in Accounting Policies

Effective January 1, 2009, the Company adopted the amendment to an accounting standard related to financial instruments, and two new Emerging Issues Committee abstracts related to credit risk and the fair value of financial assets and financial liabilities and mining exploration costs that were issued by the Canadian Institute of Chartered Accountants ("CICA"). The CICA amendment, new standard and abstracts are as follows:

Effective January 1, 2009, the Company adopted the amendment to Section 3862, Financial Instruments – Disclosures. This new Section establishes additional disclosure requirements regarding the three-level fair value hierarchy based on data used to evaluate the company's investments. Adoption of this standard did not have any material impact on the Company's consolidated financial statements.

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

3. Changes in Accounting Policies (cont'd)

In January 2009, the CICA issued EIC-173, which provides guidance on how to take into account credit risk of an entity and counterparty when determining the fair value of financial assets and financial liabilities, including derivative instruments. This Abstract applies to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2009.

Effective January 1, 2009, the Company adopted the new accounting recommendations contained in EIC-174 "Mining Exploration Costs" published in March 2009 by the Emerging Issues Committee of the CICA. The EIC provides guidance on the accounting and the impairment review of exploration costs. The application of this EIC did not have any impact on the consolidated financial statements.

Change in Accounting Estimates

Historically, the basis for calculating the amortization of exploration and development costs that were transferred to property, plant and equipment when a mining property went into production was to use proven and probable reserves. Since January 1, 2009, the amortization basis of these exploration and development costs is over the proven and probable reserves, as well as the measured and indicated resources. In effect, given the pace of exploration and the structure of the property, the proven and probable reserves known today do not appropriately reflect the useful life of assets and the life of the mine. Based on the Company's historical conversion of resources into reserves and its exploration strategy, the Company is confident that it will be able to convert the resources into reserves in the near future. Management believes that the amortization expense calculated on this new basis reflects a better use of its assets and their economic value. This is a change to the accounting estimate resulting from new information and, therefore, requires prospective application from January 1, 2009. Since the quantities of reserves and resources differ from the previous base used, this resulted in reducing the amortization and depletion expense for 2009. The amortization base is updated on an annual basis based on the technical report in compliance with National Instrument 43-101.

New Accounting Standards Issued But Not Yet in Force

In January 2009, the CICA issued Section 1601 "Consolidated Financial Statements" and Section 1602, "Non-controlling Interests," which together replaces Section 1600, "Consolidated Financial Statements." Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. These standards are equivalent to the corresponding provisions of IFRS standard, IAS 27 (Revised), "Consolidated and Separate Financial Statements." The sections apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. The Company is currently evaluating the impact of the adoption of this new Section on these consolidated financial statements.

In January 2009, the CICA issued Section 1582, "Business Combinations," which replaces Section 1581, "Business Combinations." The Section establishes standards for the accounting for a business combination. It provides the Canadian equivalent to the IFRS standard, IFRS 3 (Revised), "Business Combinations." The Section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. The Company is currently evaluating the impact of the adoption of this new Section on these consolidated financial statements.

Malaga Inc.

Notes to consolidated financial statements
December 31, 2009 and 2008

4. Short-Term Investments

	2009 \$	2008 \$
Guaranteed term deposits carrying interest at a rate of 1.6 %, matured on November 12, 2009	-	800,000

5. Accounts Receivable

	2009 \$	2008 \$
Accounts receivable	77,722	1,337,700
Sale taxes receivable	626,225	440,791
Advances to suppliers	30,057	131,609
Advances to a related company	551,621	142,064
Accounts receivable from an affiliated company	226,317	48,388
	<u>1,511,942</u>	<u>2,100,552</u>

6. Inventories

	2009 \$	2008 \$
Finished products	260,819	283,228
Inventory in transit	1,206,071	664,262
	<u>1,466,890</u>	<u>947,490</u>
Write-down of inventory value	(485,252)	-
	981,638	947,490
Work in process	56,247	46,413
Supplies	331,538	465,506
	<u>1,369,423</u>	<u>1,459,409</u>

The cost of inventory charged to expense represents all cost of sales and essentially all amortization. As at December 31, 2009, a write-down of inventories in the amount of \$485,252 (nil in 2008) was included in the cost of sales to reflect the net realizable value.

Malaga Inc.

Notes to consolidated financial statements
December 31, 2009 and 2008

7. Investments

	2009	2008
	\$	\$
Dynacor		
Investment at beginning of year	2,255,130	2,046,540
Share of net earnings (loss) for the year	(865,270)	208,590
Investment at end of year	<u>1,389,860</u>	<u>2,255,130</u>
Promissory note receivable from Dynacor, without interest, convertible into common shares at \$0.40 per share (6,466,035 shares) at the option of Dynacor	<u>2,586,414</u>	<u>2,586,414</u>
	3,976,274	4,841,544
Impairment in investment value	<u>(1,504,332)</u>	<u>-</u>
Total investment in Dynacor	2,471,942	4,841,544
Hidroeléctrica Pelagatos S.A.C. at equity	<u>-</u>	<u>6,101</u>
	<u>2,471,942</u>	<u>4,847,645</u>

As at December 31, 2009 the fair market value of the total investment in Dynacor Gold Mines Inc. amounted to \$2,471,942. Based on the share price at December 31, 2009, a reduction in the value of the investment of \$1,504,332 was recorded during the year to reflect its fair value.

8. Property, plant and equipment

	2009			2008		
	Cost	Accumulated amortization and depletion	Net book value	Cost	Accumulated amortization and depletion	Net book value
	\$	\$	\$	\$	\$	\$
Mining property	7,829,516	4,584,807	3,244,709	6,280,477	1,316,015	4,964,462
Land	113,656	0	113,656	113,656	-	113,656
Building	444,347	66,119	378,228	444,347	46,212	398,135
Plant and mining equipment	7,312,778	2,898,385	4,414,393	4,678,136	1,957,943	2,720,193
Vehicles	114,660	59,592	55,068	55,723	55,723	-
Office equipment	109,246	72,708	36,538	106,634	57,983	48,651
	<u>15,924,203</u>	<u>7,681,611</u>	<u>8,242,592</u>	<u>11,678,973</u>	<u>3,433,876</u>	<u>8,245,097</u>
Assets under capital leases						
Plant and mining equipment	702,366	226,110	476,256	462,951	130,811	332,140
Vehicles	190,023	107,525	82,498	261,879	87,211	174,668
TOTAL	<u>16,816,592</u>	<u>8,015,246</u>	<u>8,801,346</u>	<u>12,403,803</u>	<u>3,651,898</u>	<u>8,751,905</u>

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

9. Mining properties and deferred development and exploration expenses

	Huayllapon I	Huayllapon II	Huaura II	Consuzo	Other	2009 Total
Mining properties	\$	\$	\$	\$	\$	\$
Balance, beginning of period	-	-	115,822	1,491	55,119	172,432
Acquisitions	-	-	-	-	-	-
Balance, end of period	-	-	115,822	1,491	55,119	172,432
Development and exploration expenses						
Balance, beginning of period	1,549,039	-	3,572,811	-	-	5,121,850
Underground exploration and development expenses	-	444,455	1,346,694	497,878	-	2,289,027
Transferred to property, plant and equipment	(1,549,039)	-	-	-	-	(1,549,039)
Balance, end of period	-	444,455	4,919,505	497,878	-	5,861,838
TOTAL	-	444,455	5,035,327	499,369	55,119	6,034,270

	Huayllapon I	Huaura II	Consuzo	Other	2008 Total
Mining properties	\$	\$	\$	\$	\$
Balance, beginning of the year	-	115,822	1,491	53,432	170,745
Acquisitions	-	-	-	1,687	1,687
Balance, end of the year	-	115,822	1,491	55,119	172,432
Development and exploration expenses					
Balance, beginning of the year	766,200	1,055,387	-	-	1,821,587
Underground exploration and development expenses	782,839	2,517,424	-	-	3,300,263
Balance, end of the year	1,549,039	3,572,811	-	-	5,121,850
TOTAL	1,549,039	3,688,633	1,491	55,119	5,294,282

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 627 hectares. The Huayllapon1 area was put into commercial operation during the first quarter of 2009. Therefore, the cost of development and exploitation in the amount of \$1,549,039 was 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 Alonsi Fenix, Santa Marta, Sauco, Violeta, Candela veins and the area not in production of the Consuelo vein. The Consuzo Loreta sector includes the Loreta and Maria Ofelia veins.

Malaga Inc.

Notes to consolidated financial statements
December 31, 2009 and 2008

10. Bank Loans

	2009	2008
	\$	\$
11% to 14% promissory notes payable in US dollars, for an amount of US\$715,000, paid in January and March 2009	-	876,592
	<u>-</u>	<u>876,592</u>

11. Accounts payable and accrued liabilities

	2009	2008
	\$	\$
Accounts payable and accrued liabilities	4 378 657	4 797 639
Salaries and other	545 693	379 166
Accounts payable to a related company	313 317	-
	<u>5 237 667</u>	<u>5 176 805</u>

12. Long-Term Debt

	2009	2008
	\$	\$
Advance on future sales payable to the customer, without interest, maturing February 28, 2014 (US\$ 1.2M, \$1.5M CAD) a)	647,286	-
Loan payable to the 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 (US\$ 3.8M, \$4.5M CAD) a)	2,635,677	-
7.6% unsecured loan payable to the Peru tax authorities in 120 monthly instalments of 2,544 peruvian soles maturing in April 2012	40,547	41,698
Interest due to the workers of Peru, without interest and repayable on the basis of profits earned in the subsidiary, unsecured	125,972	135,670
	<u>3,449,482</u>	<u>177,368</u>
Less: current portion	<u>(774,637)</u>	<u>(13,899)</u>
	<u>2,674,845</u>	<u>163,469</u>

a) On April 1 2009, the Company entered into a financing agreement whereby it received an advance on sales of US\$1.2M (\$1.5M CAD), bearing no interest, repayable on the last sales of the sales agreement. This amount has been discounted at an effective rate of 17%, or US\$547,392 (\$692,068 CAD). The difference of \$825,092 between the amount received and the liability was initially recorded as deferred revenue and will be recognized as revenue over the shipments expected under the sales agreement.

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

12. Long-Term Debt (cont'd)

In addition, the Company received a loan of US\$3.8M (\$4.5 million CAD) secured by 3.5 million common shares of Dynacor Gold Mines Inc. which the Company owns, that is payable in monthly instalments from the thirteenth month after closing the agreement. This loan will be 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. The discount was treated as a conversion option and recorded as a component of equity. The amount of the loan, net of the conversion option of \$319,903, has been discounted at an effective rate of 17%, or US\$2,285,556 (\$2,704,390 CAD). The difference of \$1,477,217 between the amount received and the liability was initially recorded as deferred revenue and will be recognized as revenue over the expected shipments under the sales agreement.

The assets of the subsidiaries have been pledged as collateral for the loan with the customer. As at December 31, 2009, the book value of assets pledged as security amounted to \$17.6M.

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

	\$
2010	774,215
2011	1,009,511
2012	1,002,137
2013	998,450
2014	1,636,785

13. Obligations under capital leases

The future minimum lease payments due for the next three years are as follows:

	2009	2008
	\$	\$
2009	-	316,680
2010	294,685	208,320
2011	156,972	71,481
2012	63,563	-
	<u>515,220</u>	<u>596,481</u>
Less: implicit interest from 8% to 14% (2008 - 10%)	<u>(44,446)</u>	<u>(61,652)</u>
	470,774	534,829
Less: amount due within one year	<u>(264,030)</u>	<u>(277,337)</u>
	<u>206,744</u>	<u>257,492</u>

Malaga Inc.

Notes to consolidated financial statements
December 31, 2009 and 2008

14. Asset retirement obligations for property, plant and equipment

The Company's operations are governed by a mining agreement covering the protection of the environment. The Company will implement progressive measures for rehabilitation work during the operation, closing down and follow-up work upon closing of the mine. Consequently, the Company accounted for its asset retirement obligations for the property, plant and equipment using cost estimates. These estimates are subject to change following modifications to laws and regulations or as new information become available.

The table below presents the evolution of the asset retirement obligations for the transformation plant for the year.

	2009	2008
	\$	\$
Balance at the beginning of the year	498,845	1,087,920
Increase due to accretion expense	80,000	75,086
Revision of estimated cash flows	-	(664,161)
Balance at the end of the year	<u>578,845</u>	<u>498,845</u>

The estimated undiscounted cash flows required to settle the asset retirement obligations for the transformation plant is \$1,107,000. These disbursements are expected to be made in the years 2027 and 2028. A 9% discount rate was used to evaluate these obligations.

15. 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 paid

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

	2009		2008	
	Number	Amount	Number	Amount
		\$		\$
Balance, beginning of year	137,117,367	38,445,305	137,117,367	38,445,305
Warrants exercised (i)	9,006,976	900,698	-	-
Shares issued (ii)	1,562,500	250,000	-	-
Share issuance expenses (i)	-	(60,000)	-	-
Balance, end of period	<u>147,686,843</u>	<u>39,536,003</u>	<u>137,117,367</u>	<u>38,445,305</u>

- i. In August 2009, the Company received gross proceeds of \$840,698, net of share issuance expenses of \$60,000, following the exercise of 9,006,976 warrants issued in June 2009 which led to the issuance of 9,006,976 common shares at \$0.10 per share.
- ii. In December 2009, the Company received gross proceeds of \$250,000 following the issuance of 1,562,500 common shares at \$0.16 per share.

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

15. Share Capital (cont'd)

b) Warrants

In 2008, 6,622,425 warrants expired without being exercised. The fair value of \$787,560 allocated to these warrants was reclassified to contributed surplus.

c) Stock option purchase plan

The Company adopted 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.

	2009		2008	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
	(en 000)	\$	(en 000)	\$
Balance, beginning of year	6,160	0.40	4,400	0.45
Granted	-	-	2,075	0.29
Cancelled or expired	(480)	0.31	(315)	0.45
Balance, end of year	5,680	0.40	6,160	0.40
Exercisable options	4,795	0.42	4,980	0.42

Outstanding options as at December 31, 2009 are as follows:

Range of exercise prices (\$)	Average residual life span (in years)	Outstanding options (in '000)	Weighted average exercise price (\$)	2009 Exercisable options (in '000)	Weighted average exercise price (\$)
0,18 à 0,27	1.1	140	0.19	140	0.19
0,28 à 0,42	4.9	3,725	0.31	2,840	0.31
0,43 à 0,69	1.7	1,345	0.56	1,345	0.56
0,70 à 0,77	7.5	470	0.77	470	0.77
0,18 à 0,77		5,680	0.40	4,795	0.42

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

15. Share Capital (cont'd)

In 2008, the fair value of the options granted was estimated at \$487,306. The fair value assigned to the options was estimated using the Black-Scholes valuation model (including a risk-free rate of 3.6%, expected volatility of 90%, 84 months of expected life and no expected dividend).

For the year ended December 31, 2009, the stock-based compensation charged to the consolidated income statement was \$153,111 compared to \$270,975 in 2008. The offsetting credit has been recorded as contributed surplus. No options were issued during the year ended December 31, 2009.

d) *Capital Management*

The Company's objectives in managing capital are the following:

1. to preserve its capacity to continue operations in order to maximize the return to its shareholders and maintain an optimal capital structure in order to increase the value of shareholders' capital in the long term;
2. to ensure the Company has sufficient capital to meet its short-term needs and ensure the development of its projects and mining activities;
3. to satisfy the external requirements with regards to the capital needed to respect any lending agreements
4. to maintain an optimal capital structure in order to minimize the cost of debt financing.

The Company objectives remain unchanged from 2008.

The Company's capital structure consists of common shares, warrants, note payable and stock options. The Company manages its capital structure and makes changes pursuant to economic conditions and conditions related to its assets. The Company has the ability to raise capital as required to meet its requirements, therefore it does not have a targeted debt to capital ratio. The Company also possesses the ability to raise debt financing to maintain equilibrium debt and shareholder equity.

The Company is not subject to any requirements with regards to capital.

16. Contributed Surplus

Net change in contributed surplus is as follows:

	2009	2008
	\$	\$
Balance at beginning of year	3,386,533	2,327,998
Stock-based compensation	153,111	270,975
Ordinary warrants expired	-	442,167
Broker warrants expired	-	345,393
Balance at end of year	<u>3,539,644</u>	<u>3,386,533</u>

Malaga Inc.

Notes to consolidated financial statements
December 31, 2009 and 2008

17. Income taxes

The reconciliation of the income tax expense calculated using the combined federal and Quebec statutory tax rate and the Peruvian statutory tax rate to the income tax expense per the financial statements as of December 31, 2009 and 2008 is as follows:

	Canada	Peru	Total 2009
Tax rates	30.90%	30,00 %	
	\$	\$	\$
Loss before income taxes	(5,294,686)	(2,340,583)	(7,635,269)
Income taxes at the composite statutory rates	(1,636,058)	(702,175)	(2,338,233)
Differences attributable to:			
Non deductible expenses	678,384	107,651	786,035
Change in statutory rates	141,349	-	141,349
Losses from previous years expired	177,031	-	177,031
Deductible temporary differences not previously accounted for	4,585	461,117	465,702
Other	1,111	-	1,111
Valuation allowance	633,598	133,407	767,005
Current income tax expense	-	-	-

	Canada	Peru	Total 2008
Tax rates	30.90%	30,00 %	
	\$	\$	\$
Loss before income taxes	(136,422)	(2,992,176)	(3,128,598)
Income taxes at the composite statutory rates	(42,154)	(897,653)	(939,807)
Differences attributable to:			
Non deductible expenses	85,158	264,345	349,503
Unrealized foreign exchange gain	(173,169)	-	(173,169)
Impact of rate change in future income taxes	286,747	-	286,747
Losses from previous years expired	183,312	-	183,312
Deductible temporary differences not previously accounted for	(371,659)	55,516	(316,143)
Valuation allowance	31,765	577,792	609,557
Current income tax expense	-	-	-

Malaga Inc.

Notes to consolidated financial statements
December 31, 2009 and 2008

17. Income taxes (cont'd)

	2009	2008
	\$	\$
Future income tax assets		
Share issuance expenses	80,927	151,480
Mining properties and deferred development and exploration expenses	1,193,705	431,141
Non-capital losses	2,590,285	1,842,052
Re-evaluation of investments	318,711	-
Unrealized foreign exchange losses	38,468	-
Capital losses	165,881	214,554
	<u>4,387,977</u>	<u>2,639,227</u>
Future income tax liabilities		
Property, plant and equipment	(429,167)	
Unrealized foreign exchange gain	-	(207,760)
Valuation allowance	<u>(3,958,810)</u>	<u>(2,431,467)</u>
	<u>-</u>	<u>-</u>

As at December 31, 2009, the company had non-capital losses for income tax purposes which expire as follows:

	Federal	Provincial
	\$	\$
2010	20,640	17,259
2014	433,121	424,268
2015	760,134	755,483
2016	1,508,225	1,504,100
2027	2,044,826	2,040,619
2028	1,501,923	1,501,923
2029	1,414,185	1,414,185
	<u>7,683,054</u>	<u>7,657,837</u>

In addition, the Company has accumulated carry forward losses in foreign subsidiaries that can be used in deductions of future taxable income. As at December 31, 2009, subsidiaries located in Peru showed carry forward losses expiring as follows:

	\$
2012	358,487
2013	168,031
	<u>526,518</u>

Malaga Inc.

Notes to consolidated financial statements
December 31, 2009 and 2008

18. Information Included in the Statements of Cash Flows

	2009	2008
	\$	\$
Changes in non-cash working capital items		
Accounts receivable	424,357	1,508,223
Income taxes receivable	(74,276)	(674,695)
Inventories	399,063	(460,722)
Prepaid expenses	(84,802)	71,405
Accounts payable and accrued liabilities	439,095	1,290,884
Income taxes payable	(93,097)	(352,393)
Unearned revenue	199,065	-
	<u>1,209,405</u>	<u>1,382,702</u>
Additional information:		
Interest paid	376,957	397,189
Interest received	8,091	61,853
Income taxes paid	59,655	1,027,088
Non-cash working capital transactions:		
Depletion of inventory capitalized	309,077	-
Assets acquired through capital leases	321,691	331,914

19. Commitments

The future minimum lease payments under operating leases for office space expiring in 2012 are as follows:

	\$
2010	104,456
2011	104,456
2012	17,410
	<u>226,322</u>

For fiscal year 2010 the Company has contractual commitments for acquisition of property, plant and equipment totalling \$82,438.

20. Financial Instruments

Risk Exposure and Management

The Company is exposed to a certain number of risks at different levels.

A. Market Risk

i. Fair Value

The carrying amounts of financial instruments are presented in the consolidated balance sheet at fair value or amortized cost according to the Company's accounting policies. Short-term financial assets and liabilities, which include short-term investments, accounts receivable, and accounts payable, approximate fair values due to the immediate or short-term maturities of these financial instruments. In addition the fair value of the long-term debt and obligations under capital leases are approximately equal to their book value.

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

20. Financial Instruments (cont'd)

ii. Hierarchy of assessments at fair value

In 2009, Chapter 3862 of the CICA Handbook "Financial Instruments – Disclosures" ("Section 3862") was amended to require information on the data used for assessments at fair market value including their classification hierarchy that classifies, according to three levels of importance, the data used in determining fair value. The three levels of hierarchy of assessments at fair value are as follows:

- Level 1 – the unadjusted quoted prices in active markets for identical assets or liabilities;
- Level 2 – data other than quoted prices that are observable for the asset or liability, directly or indirectly;
- Level 3 – data that are not based on observable market data.

The only financial instruments measured at fair value are cash and cash equivalents, which are classified as Level 1.

iii. Interest Rate Risk

Current financial assets and financial liabilities are generally not exposed to interest rate risk due to their short term nature and/or because they do not bear interest.

The advance on future sales does not bear interest and is therefore not subject to the risk of interest rate fluctuations.

As a borrower of funds, the Company is subject to risks associated to fluctuations in interest rates. The Company entered into a long term financing agreement that bears interest at the 12 month LIBOR RATE. As at December 31, 2009, the outstanding balance of the long term debt that bears interest at the 12 month LIBOR RATE is \$3.8 million US (\$4.5 million CAD). For 2009, a variation in the 12 month LIBOR rate of 5% to 10% would not have a material impact on the consolidated financial statements.

iv. Foreign Exchange Risk

The functional currency of the company is the Canadian Dollar. The Company is subject to foreign exchange risk as a significant portion of its operating costs and revenues are denominated in United States dollars and in Peruvian new soles. The Company is, therefore, subject to gains and losses due to fluctuations in the United States dollars and the Peruvian new soles relative to the Canadian dollar. The Company does not use derivatives to manage the exposure to foreign exchange risk.

The Company has balances of cash and cash equivalents, receivables as well as payables in foreign currencies and is therefore exposed to foreign exchange risk on these amounts. The balances in foreign currencies as at December 31, 2009 and 2008 are as follows:

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

20. Financial Instruments (cont'd)

	2009		2008	
	United States dollars	Nuevo soles	United States dollars	Nuevo soles
Cash and cash equivalents	637,008	249,295	(21,667)	(316,863)
Accounts receivable	407,793	1,811,312	1,213,028	309,651
Accounts payable	<u>(2,296,770)</u>	<u>(7,293,191)</u>	<u>(2,185,320)</u>	<u>(5,705,452)</u>
Net balance	<u>(1,251,969)</u>	<u>(5,232,584)</u>	<u>(993,959)</u>	<u>(5,712,664)</u>
Equivalent in Canadian \$	<u>(1,315,819)</u>	<u>(1,895,795)</u>	<u>(1,212,145)</u>	<u>2,231,509</u>

In addition, the Company has income taxes receivable in the amount of 1,919,463 nuevo soles (\$695,432), income taxes payable in the amount of 126,954 nuevo soles (\$45,996), as well as sales taxes receivable in the amount of 1,728,444 nuevo soles (\$626,225).

Assuming all other variables constant, given an increase or a decrease in the Canadian dollar of 5% against the Peruvian nuevo soles, the net income of the Company for the year ended December 31, 2009 would have varied by approximately \$64,000.

Assuming all other variables constant, given an increase or a decrease in the Canadian dollar of 5% against the United States dollar, the net income of the Company for the year ended December 31, 2009 would have varied by approximately \$66,000.

v. Price Risk

The Company's profitability is exposed to commercial risks notably those linked to the price of tungsten. The Company does not have financial instruments exposed to price risk.

B. Credit Risk

The Company is exposed to a significant credit risk in regards to its trade accounts receivable since it has only one customer. The Company conducts a review of all accounts receivable and records a provision for doubtful accounts when they are deemed uncollectable.

The Company has reduced its credit risk by investing its cash, cash equivalents and short-term investments with a Canadian chartered bank.

C. Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its obligations as they fall due.

Malaga Inc.

Notes to consolidated financial statements
December 31, 2009 and 2008

20. Financial Instruments (cont'd)

The contractual commitments for liabilities as at December 31, 2009 are as follows:

	Total	Less than 6 months	Between 6 and 12 months	Between 1 and 4 years
	\$			
Accounts payable and accrued liabilities	5,237,667	4,563,521	674,146	-
Long-term debt	5,493,050	278,246	520,021	4,694,783
Obligations under capital leases	470,744	132,015	132,015	206,714
	<u>11,201,461</u>	<u>4,973,782</u>	<u>1,326,182</u>	<u>4,901,497</u>

The contractual commitments for liabilities as at December 31, 2008 are as follows:

	Total	Less than 6 months	Between 6 and 12 months
	\$		
Bank loans	876,592	876,592	-
Accounts payable and accrued liabilities	5,176,805	5,176,805	-
Long-term debt	13,899	6,950	6,949
Obligations under capital leases	277,337	138,669	138,668
	<u>6,344,633</u>	<u>6,199,016</u>	<u>145,617</u>

In addition, the Company has income taxes payable in the amount of \$45,996. As at December 31, 2009 the Company had \$1,149,101 in cash, \$1,511,942 in accounts receivable, \$695,432 in income taxes receivable and \$1,369,423 in inventories.

21. Related Party Transactions

The following summarizes the Company's related party transactions with its affiliated company Dynacor Gold Mines Inc., on which it exercises significant influence, that have not been previously disclosed:

	2009	2008
	\$	\$
General and administrative expenses	<u>542,629</u>	<u>523,423</u>

These transactions take place in the Company's normal course of business and are measured at their exchange value, which is the amount of the consideration determined by and agreed to by the related parties.

22. Contingencies

The operations of the Company are subject to Peruvian governmental laws and regulations regarding the environment. As at December 31, 2009, to the best of knowledge of its management, the Company is operating in conformity with the laws and regulations in Peru.

Malaga Inc.

Notes to consolidated financial statements

December 31, 2009 and 2008

23. Comparative figures

Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year.