

**HILLSBOROUGH RESOURCES LIMITED**  
**CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED DECEMBER 31, 2004**

## **MANAGEMENTS' RESPONSIBILITY FOR FINANCIAL REPORTING**

### **To the Shareholders of Hillsborough Resources Limited**

The accompanying consolidated financial statements of the Corporation were prepared by management in accordance with accounting principles generally accepted in Canada, and within the framework of the summary of significant accounting policies in the notes to these financial statements. Management is responsible for all information in the Annual Report. All financial and operating data in the Annual Report is consistent, where appropriate, with that contained in the consolidated financial statements.

A system of accounting and control is maintained in order to provide reasonable assurance that the assets are safeguarded and that transactions are properly recorded and executed in accordance with management's authorization. The system includes established policies and procedures, the selection and training of qualified persons as is reasonably possible, and an organization providing for the appropriate delegation of authority and segregation of responsibilities for a Corporation of the size of Hillsborough Resources Limited.

The Board of Directors discharges its responsibilities for the consolidated financial statements primarily through the activities of its Audit Committee. This Committee meets with management and the Corporation's independent auditors to assure that it is performing its responsibility to maintain financial controls and systems and to approve all financial information released to the public. The Audit Committee also meets with the independent auditors to discuss the scope and the results of the audit and the audit report prior to submitting the financial statements to the Board of Directors for approval.

The consolidated financial statements for 2004 and 2003 have been audited on behalf of the shareholders by the Corporation's independent auditors, PricewaterhouseCoopers LLP, in accordance with Canadian generally accepted auditing standards. The auditors' report outlines the scope of their audit and their opinion on these consolidated financial statements.

**"David J. Slater"**  
(signed)

**David J. Slater**  
*President and Chief Executive Officer*

*March 23, 2005*

**"David E. Whittle"**  
(signed)

**David E. Whittle**  
*Chief Financial Officer*

**Auditors' Report**

to the Shareholders of Hillsborough Resources Ltd.

We have audited the consolidated balance sheets of **Hillsborough Resources Ltd.** as at December 31, 2004 and 2003 and the consolidated statements of operations and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits 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, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*/s/ PricewaterhouseCoopers LLP*

**Chartered Accountants**

Vancouver, British Columbia  
March 3, 2005, except for note 18,  
which is as of March 23, 2005

**HILLSBOROUGH RESOURCES LIMITED**  
**CONSOLIDATED BALANCE SHEETS**  
**AS AT DECEMBER 31**

	<b>2004</b>	<b>2003</b>
		<b>As Restated (see note 2(g))</b>
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 6,903,589	\$ 1,380,514
Marketable securities	21,432	30,362
Receivables	2,145,318	1,340,423
Inventories (see note 3)	1,814,520	4,534,337
Prepaid expenses and deposits	316,068	291,019
Assets held for sale	56,194	118,606
	11,257,121	7,695,261
<b>Property, Plant and Equipment</b> (see note 4)	14,956,399	7,691,370
<b>Deposits and Deferred Charges</b> (see note 5)	1,080,972	1,598,154
	\$ 27,294,492	\$ 16,984,785
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable and accrued liabilities	\$ 2,246,189	\$ 1,526,886
Income and resource taxes payable	44,921	6,892
Current portion of loans and lease obligations	-	18,127
	2,291,110	1,551,905
<b>Asset Retirement Obligation</b> (see note 6)	1,092,896	737,689
	3,384,006	2,289,594
<b>Shareholders' Equity</b>		
Share capital (see note 7)	19,432,320	12,247,043
Warrants (see note 8)	351,000	200,000
Contributed surplus	1,713,593	1,713,593
Stock options (see note 9)	69,294	1,332
Retained earnings	2,344,279	533,223
	23,910,486	14,695,191
	\$ 27,294,492	\$ 16,984,785

**APPROVED ON BEHALF OF  
THE BOARD OF DIRECTORS**

**"WINSTON D. STOTHERT"**

*(signed)*

Director

**"TOM LINDSAY"**

*(signed)*

Director

**COMMITMENTS** (see note 13)

**CONTINGENCIES** (see note 14)

**SUBSEQUENT EVENTS** (see note 18)

**HILLSBOROUGH RESOURCES LIMITED**  
CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS  
FOR THE YEAR ENDED DECEMBER 31

	2004	2003
		<b>As Restated (see note 2(g))</b>
<b>Coal Revenues</b>	\$ 23,395,086	\$ 13,467,011
<b>Production Cost of Coal Sold</b>	19,228,455	11,462,720
<b>Contribution from Sales</b>	4,166,631	2,004,291
<b>Operating Expenses</b>		
Accretion of asset retirement obligation	62,235	45,023
Amortization of general and administrative assets	32,256	29,091
Selling, general and administrative	2,026,179	1,692,686
	2,120,670	1,766,800
<b>Earnings from Operations</b>	2,045,961	237,491
<b>Other Income (Expenses)</b>		
Write-down of property, plant and equipment (see note 4)	(346,030)	(7,184)
Write-down of marketable securities	(8,930)	(41,079)
Reversal of unsecured creditor liabilities (see note 10)	-	682,557
Other income and expenses, net (see note 10)	206,209	50,692
<b>Earnings Before Provision for Taxes</b>	1,897,210	922,477
<b>Provision for Taxes</b> – current (see note 11)	86,154	48,141
<b>Net Earnings</b>	1,811,056	874,336
<b>Retained Earnings (Deficit) – Beginning of Year, As Previously Reported</b>	808,614	(110,715)
Adjustment on adoption of new accounting standards pertaining to asset retirement obligations (see note 2(g))	(275,391)	(230,398)
<b>Retained Earnings (Deficit) – Beginning of Year, As Restated on Adoption of New Accounting Standards</b>	533,223	(341,113)
<b>Retained Earnings – End of Year</b>	\$ 2,344,279	\$ 533,223
<b>Earnings Per Share</b> (see note 12)		
Basic	\$0.06	\$0.03
Diluted	\$0.05	\$0.03

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

**HILLSBOROUGH RESOURCES LIMITED**  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE YEAR ENDED DECEMBER 31

	2004	2003
		<b>As Restated (see note 2(g))</b>
<b>Cash Flows from Operating Activities</b>		
Net earnings	\$ 1,811,056	\$ 874,336
Items not affecting cash from operations –		
Accretion of asset retirement obligation	62,235	45,023
Amortization and depletion	994,065	643,906
Stock based compensation expense	87,709	1,332
Non-cash financing charges	24,986	-
Write-down of property, plant and equipment	346,030	7,184
Write-down of marketable securities	8,930	41,079
Reversal of unsecured creditor liabilities	-	(682,557)
(Gain) loss on disposition of property, plant and equipment, net	(42,369)	1,308
	3,292,642	931,611
Net changes in non-cash working capital balances related to operations (see note 17)	2,709,614	(1,469,472)
	6,002,256	(537,861)
<b>Cash Flows from Investing Activities</b>		
Purchase of property, plant and equipment	(8,184,111)	(1,446,654)
Proceeds from disposition of property, plant and equipment	47,903	-
Change in reclamation deposits and deferred charges	515,610	169,333
	(7,620,598)	(1,277,321)
<b>Cash Flows from Financing Activities</b>		
Repayment of loans and lease obligations	(18,127)	18,127
Common shares issued under private placement	6,152,745	-
Common shares issued on exercise of warrants	899,899	-
Common shares issued on exercise of stock options	106,900	-
	7,141,417	(18,127)
<b>Net Cash Flows</b>	5,523,075	3,177,569
<b>Cash and Cash Equivalents – Beginning of Year</b>	1,380,514	(1,797,055)
<b>Cash and Cash Equivalents – End of Year</b>	\$ 6,903,589	\$ 1,380,514

**SUPPLEMENTAL INFORMATION**

**Cash Flows Arising From Interest Paid and Received  
and Income and Resource Taxes Paid**

Interest received	\$ 49,000	\$ 69,000
Interest paid	\$ 16,000	\$ 19,000
Income and resource taxes paid	\$ 55,000	\$ 56,000

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

**1. Nature of Operations**

The Corporation's business comprises the operation of coal mines, the development of new coal resources and the development of opportunities related generally to coal and industrial minerals. The Corporation's coal interests are targeted to both the thermal and coking coal markets. The Corporation's principal subsidiary is Quinsam Coal Corporation, which operates the Quinsam coal mine on Vancouver Island, British Columbia. The Corporation has additional coal interests under development in British Columbia, and in February 2005 acquired a coal property located in Tennessee on which the Corporation is commencing the process of bringing an underground coal mine into operation.

**2. Significant Accounting Policies**

**(a) Basis of Consolidation and Financial Statement Preparation**

These consolidated financial statements include the accounts of the Corporation and all of its subsidiaries. These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"), and are reported in Canadian dollars.

**(b) Use of Estimates**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts and the valuation of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period reported. Significant areas requiring the use of management's judgement include evaluating the carrying values of property, plant and equipment, determining amortization rates, determining coal reserves and resources, estimating future income tax assets and liabilities, estimating asset retirement obligations including future environmental obligations and site restoration costs and determining the value of stock-based compensation. By their nature, such estimates are subject to measurement uncertainty. Actual results could differ, and such estimates may be subject to change in the future.

**(c) Cash and Cash Equivalents**

Cash and cash equivalents comprise cash on hand, demand deposits, term deposits and guaranteed investment certificates that mature within three months or less from the date of purchase and can readily be liquidated to known amounts of cash.

**(d) Marketable Securities**

Marketable securities are recorded at the lower of cost and fair market value.

**(e) Inventories**

Coal inventories, including raw and clean coal, are valued at the lower of average cost and net realizable value. The cost of coal inventory includes direct costs of production as well as such overhead and amortization and depletion costs as are applicable to production.

Supplies inventory is valued at the lower of average cost and net realizable value.

Effective for the Corporation's 2004 fiscal year, the Canadian Institute of Chartered Accountants (CICA) Handbook has been confirmed as the primary source of Canadian GAAP, with secondary sources including International Accounting Standards and US GAAP. Industry practice is no longer considered a valid source of GAAP. The Corporation is therefore now including amortization and depletion charges in the cost of inventory. Previously, amortization and depletion were charged directly to earnings. The new policy does not affect reported income in any prior year as it requires the change to be implemented prospectively at the start of the Corporation's 2004 fiscal year. As of December 31, 2004, the Corporation has included \$70,925 of amortization and depletion in the cost

of its coal inventories. Also as a consequence of this change, amortization and depletion applicable to production sold during a year has been reclassified for presentation purposes in the statement of operations to production cost of coal sold, and this reclassification has been effected retroactively.

**(f) Property, Plant and Equipment**

Plant and equipment is recorded at cost less accumulated amortization and write-downs. Amortization for plant assets that are incorporated into mine operations is provided on the straight-line method based on the estimated useful lives of the assets according to the current mine plan. Amortization for equipment and other plant assets is generally provided on the declining balance method based on the estimated useful lives of the assets. These amortization rates by principal asset class are as follows:

Buildings	5%
Equipment	30% to 50%
Furniture and fixtures	20%
Middle Point barge facility	20 years

Mine properties are properties which are either in production or for which the decision has been taken to bring the property into production and construction has commenced. Resource properties are properties under exploration and development. Investments in mine and resource properties are recorded at cost. All costs of acquiring such properties are capitalized, including any related financing or interest costs, and the costs of exploration and mine development activities thereon are deferred on a project basis. When a property is put into commercial production, the capitalized acquisition, exploration and mine development costs are amortized on the units of production method. If a mine or resource property is abandoned, the carrying amount is written down to its estimated recoverable amount. The recovery of the carrying amount of a resource property in the pre-commercial production stage is dependent upon the development of economically recoverable reserves, future profitable production or the proceeds from its disposition.

The Corporation performs impairment tests periodically on its property, plant and equipment assets which compare expected undiscounted future cash flows from these assets to their carrying amounts. If shortfalls exist, assets are written down to the discounted value of the future cash flows.

**(g) Asset Retirement Obligation**

Effective for the year ending December 31, 2004, the Corporation has adopted the recommendations of the CICA Handbook Section 3110, "Asset Retirement Obligations". Under this Section, future obligations to retire an asset, including dismantling, remediation and ongoing treatment and monitoring of the site, are recognized and recorded as a liability at fair value as at the time the asset is acquired or the event occurs giving rise to such an obligation. The liability is accreted over time through periodic charges to earnings. The corresponding asset retirement cost is capitalized as part of the asset's carrying value, and is amortized over the asset's useful life in accordance with the Corporation's property, plant and equipment amortization policies.

Previously, the Corporation provided for estimated reclamation, site restoration and other closure costs using the units-of-production method based upon the applicable asset usage or mine plan commencing when a reasonably accurate estimate of the cost could be made. This change in accounting policy has been adopted retroactively, resulting in an increase in long-term liability of \$450,226 and an increase to property, plant and equipment of \$174,835 as at December 31, 2003, a reduction of reported income for 2003 of \$44,993 and a decrease to opening retained earnings for 2003 of \$230,398.

**(h) Revenue Recognition**

Revenue from the sale of coal is recognized when there is a contractual agreement for the sale of coal and the coal has been delivered under the terms of that agreement such that the risk and title

of ownership of the coal has passed to the customer. Recognition of any revenue is subject to the provision that ultimate collection be reasonably assured at the time of recognition.

**(i) Stock-Based Compensation Plans**

The Corporation accounts for its stock-based compensation plans in accordance with the recommendations of CICA Handbook Section 3870, "*Stock-Based Compensation and Other Stock-Based Payments*", which requires the fair value based method of accounting for all stock-based compensation earned during the year. Under this method, the fair value of options granted to employees is estimated on the date of grant and is recognized as compensation expense over the vesting period of the options. Consideration paid on exercise of stock options is credited to share capital.

**(j) Income Taxes**

The Corporation follows the asset and liability method of tax allocation accounting. Under this method, current income taxes are recognized for the estimated income taxes payable for the current year. Future tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantial enactment. The amount of future income tax assets recognized is limited to the amount that is estimated as more likely than not to be realized.

**(k) Translation of Foreign Currencies**

The Corporation's functional currency, or unit of measure, is the Canadian dollar. Transactions in foreign currencies are translated into Canadian dollars at either actual or estimated exchange rates in effect on the transaction date. Monetary assets and liabilities expressed in foreign currencies are translated into Canadian dollars at the exchange rates in effect at the balance sheet date. The resulting exchange gains and losses are recognized in income.

**(l) Derivative Transactions**

The Corporation does not hedge the price of its coal sales. Some coal contracts are denominated in currency other than the Canadian dollar. The Corporation may enter into foreign exchange contracts to mitigate the exposure to exchange rate changes on these anticipated sales. Gains or losses from such foreign exchange contracts are reported in Other Income or Expenses as they are not specifically identified as foreign currency hedges.

**(m) Earnings Per Share**

Earnings per share are calculated using the weighted average number of shares outstanding. The treasury stock method is used to calculate the dilutive effect of options, warrants and similar instruments. Under this method, dilution is calculated based upon the net number of shares issued assuming "in-the-money" instruments are exercised and the proceeds are used to repurchase issued and outstanding common shares at the weighted average trading price for the period.

**(n) Comparative Information**

Certain of the comparative figures have been reclassified to conform with the current period's presentation format.

**HILLSBOROUGH RESOURCES LIMITED**  
NOTES TO FINANCIAL STATEMENTS  
FOR THE YEAR ENDED DECEMBER 31, 2004

**3. Inventories**

	<b>2004</b>	<b>2003</b>
Coal inventory	\$ 1,245,052	\$ 3,945,054
Supplies inventory	569,468	589,283
	<b>\$ 1,814,520</b>	<b>\$ 4,534,337</b>

**4. Property, Plant and Equipment**

	<b>Cost</b>	<b>Accumulated Amortization, Depletion and Write-Downs</b>	<b>2004 Net</b>
Land	\$ 1,699,375	\$ -	\$ 1,699,375
Plant and equipment	44,529,363	33,820,489	10,708,874
Furniture, fixtures and other	608,475	560,687	47,788
Mine property and development costs	1,972,568	386,711	1,585,857
Resource property and exploration costs	914,505	-	914,505
	<b>\$ 49,724,286</b>	<b>\$ 34,767,887</b>	<b>\$ 14,956,399</b>

	<b>Cost</b>	<b>Accumulated Amortization, Depletion and Write-Downs</b>	<b>2003 Net</b>
Land	\$ 1,550,026	\$ -	\$ 1,550,026
Plant and equipment	37,490,889	33,070,126	4,420,763
Furniture, fixtures and other	586,613	528,431	58,182
Quinsam power plant project	342,819	-	342,819
Mine property and development costs	1,056,356	184,674	871,682
Resource property and exploration costs	447,898	-	447,898
	<b>\$ 41,474,601</b>	<b>\$ 33,783,231</b>	<b>\$ 7,691,370</b>

During the year ended December 31, 2004, the Corporation acquired the Middle Point barge facility located near the Quinsam coal mine on Vancouver Island, British Columbia, through which the majority of the Quinsam mine production has historically been shipped. The Corporation acquired the facility for \$3,695,509, of which \$3,518,776 is recorded in plant and equipment and \$176,733 is recorded in land.

Included in plant and equipment at December 31, 2004 is \$339,794 paid in advance in respect of an acquisition of certain Tennessee mining assets that was completed subsequent to the end of the year (see note 18(b)).

During the year ended December 31, 2004, the Corporation wrote off its investment in the Quinsam power plant project and consequently recorded a charge of \$346,030.

During the year ended December 31, 2004, the Corporation entered into an option agreement to acquire a 100% interest in the Bingay Creek property, a coking coal property located in the Elk Valley region of Southeast British Columbia. Under the terms of the agreement, the Corporation has paid \$120,000 to the

**HILLSBOROUGH RESOURCES LIMITED**  
NOTES TO FINANCIAL STATEMENTS  
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optionors during 2004, and must incur a minimum of \$500,000 in exploration and development expenditures in respect of the property by August 1, 2007. The optionors have been granted royalties in respect of washed coal ranging from \$1 to \$2.75 per tonne sold and royalties in respect of raw coal ranging from 2% to 4% of sale proceeds, depending on the type of coal and the area of the property from which it is produced. One of the optionors is, and was at the time the agreement was entered into, an employee of the Corporation. Expenditures pertaining to this property have been included in resource property and exploration costs.

**5. Deposits and Deferred Charges**

	<b>2004</b>	<b>2003</b>
Deposits	\$ 993,000	\$ 1,494,000
Deferred charges	87,972	104,154
	<b>\$ 1,080,972</b>	<b>\$ 1,598,154</b>

Deposits primarily consist of interest bearing funds deposited with financial institutions as security for reclamation and environmental obligations, mining permits and other business related activities.

**6. Asset Retirement Obligation**

	<b>2004</b>	<b>2003</b>
Asset retirement obligation – beginning of year	\$ 737,689	\$ 692,666
Obligations incurred during the year	292,972	-
Accretion expense	62,235	45,023
Asset retirement obligation – end of year	<b>\$ 1,092,896</b>	<b>\$ 737,689</b>

The Corporation's asset retirement obligation arises from its obligations to undertake site reclamation and remediation in connection with its operating activities. The deposits which the Corporation has in place to secure these obligations have a fair value of approximately \$993,000 and are included in Deposits and Deferred Charges (see note 5).

The total undiscounted amount of the estimated cash flows required to settle the asset retirement obligation is estimated to be \$1,782,000 measured in 2004 dollars. While some expenditures will be incurred during the operating lives of the underlying assets to which they relate, a significant component of these cash flows will be expended towards the end of their lives, generally between 10 and 20 years in the future. In determining the carrying value of the asset retirement obligation, the Corporation has assumed a credit-adjusted risk-free discount rate of 6.5% and a long-term inflation rate of 2.5%.

**HILLSBOROUGH RESOURCES LIMITED**  
NOTES TO FINANCIAL STATEMENTS  
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**7. Share Capital**

Authorized:

- Unlimited number of common shares, without par value

<b>Issued and Outstanding</b>	<b>Number of shares</b>	<b>Amount</b>
Balance – December 31, 2002	29,681,728	\$ 12,205,483
Adjustment for issuer bid	-	41,560
Correction for rounding of fractional shares	63	-
Balance – December 31, 2003	29,681,791	12,247,043
Exercise of stock options	287,500	108,232
Exercise of warrants	2,499,720	1,024,885
Issued pursuant to Employee Share Purchase Plan	26,159	18,415
Private placement	7,000,000	6,033,745
Balance – December 31, 2004	39,495,170	\$ 19,432,320

Effective December 30, 2004, the Corporation issued on a private placement basis 5,000,000 shares at a price of \$0.90 each and 2,000,000 flow-through shares at a price of \$1.05, for gross proceeds of \$6,600,000. The agents to the private placement were paid a commission of 5.5% and received brokers' warrants to acquire 350,000 shares at any time until December 30, 2005 at a price of \$0.99 per share. After deducting the agents' commission of \$363,000, the fair value of the brokers' warrants granted of \$119,000 and other issuance expenses of \$84,255, net proceeds from the issuance were \$6,033,745.

**8. Warrants**

	<b>Number of shares issuable on exercise</b>	<b>Weighted average exercise price</b>	<b>Carrying Amount</b>
Balance – December 31, 2003 and 2002	4,499,720	\$0.36	\$ 200,000
Issued on asset acquisition (see below)	400,000	\$0.54	132,000
Issue of brokers' warrants (see note 7)	350,000	\$0.99	119,000
Exercised	(2,499,720)	\$0.36	(100,000)
Balance – December 31, 2004	2,750,000	\$0.47	\$ 351,000

During 2004, as part of the consideration paid to acquire the Middle Point barge facility (see note 4), the Corporation issued warrants to the vendor to acquire 400,000 shares at a price of \$0.54 each with a five year term. The fair value of these warrants was estimated to be \$132,000 and is included in the cost of the facility acquired.

Warrants outstanding at December 31, 2004 expire between October 6, 2006 and April 1, 2009.

**HILLSBOROUGH RESOURCES LIMITED**  
NOTES TO FINANCIAL STATEMENTS  
FOR THE YEAR ENDED DECEMBER 31, 2004

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**9. Stock-Based Compensation Plans**

The Corporation has one incentive stock option plan, as well as an employee share purchase plan.

Under the employee share purchase plan, which was implemented during 2004, an employee can elect to have an amount deducted from his or her pay which is then accumulated and, on a quarterly basis, used to acquire shares of the Corporation from treasury at the market price applicable at the end of the quarter. The Corporation effectively matches 50% of the employee's contribution by issuing additional top-up shares. The value of the top-up shares so issued during 2004 was \$18,415 and is included in stock-based compensation expense.

Under the stock option plan and at the discretion of the board of directors, the Corporation may grant incentive stock options and stock appreciation rights to directors, officers, employees and consultants. The maximum term of options granted under this plan is ten years, and the exercise price is determined at the discretion of the Directors of the Corporation subject to the provision that it not be less than the market price of the common shares at the date of granting. Options vest either immediately or within 24 months, as determined by the Directors on granting. The number of common shares issuable on exercise of stock options granted under this plan cannot exceed 3,400,000.

During the years ended December 31, 2003 and December 31, 2004, incentive stock options were granted and exercised as follows:

	<b>Number of shares issuable on exercise</b>	<b>Weighted average exercise price</b>
Balance – December 31, 2002	1,998,000	\$0.42
Granted	10,000	\$0.27
Forfeited	(56,500)	\$0.90
Balance – December 31, 2003	1,951,500	\$0.41
Granted	250,000	\$0.70
Exercised	(287,500)	\$0.37
Forfeited	(76,500)	\$0.85
Balance – December 31, 2004	1,837,500	\$0.43

All options granted during 2004 and 2003 carried exercise prices equal to the fair value of the common shares as at the granting date. The weighted average per-share fair value of options granted during 2004 was \$0.32 (2003 – \$0.13), and the stock-based compensation expense recognized for the year in respect of options granted was \$69,294 (2003 – \$1,332).

The fair value of the options at the date of grant was estimated using the Black-Scholes option pricing model, assuming a risk-free interest rate of 5% per annum, an expected life of options of approximately 2 years, an expected volatility of between 60% and 65% and no dividends (2003 – 4.3%, 3.28 years, 67% and no dividends, respectively).

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Incentive stock options outstanding at December 31, 2004 are summarized as follows:

Exercise Price	Options Outstanding			Options Exercisable	
	Number of Shares Issuable on Exercise	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number of Shares Issuable on Exercise	Weighted Average Exercise Price
\$0.00 to \$0.09	200,000	5	\$0.07	200,000	\$0.07
\$0.10 to \$0.19	350,000	5	\$0.10	350,000	\$0.10
\$0.30 to \$0.39	480,000	7	\$0.35	480,000	\$0.35
\$0.50 to \$0.59	337,500	8	\$0.53	337,500	\$0.53
\$0.60 to \$0.69	10,000	7	\$0.60	10,000	\$0.60
\$0.70 to \$0.79	217,500	10	\$0.70	85,000	\$0.70
\$0.90 to \$0.99	20,000	7	\$0.97	20,000	\$0.97
\$1.00	222,500	4	\$1.00	222,500	\$1.00
	1,837,500	7	\$0.43	1,705,000	\$0.41

**10. Other Income and Expenses**

	2004	2003
Interest income	\$ 47,550	\$ 67,539
Interest expense	(50,759)	(19,088)
Foreign exchange loss	(136,515)	(63,610)
Gain (loss) on disposition of property, plant and equipment	42,369	(1,308)
Gain on disposition of supplies inventory	35,000	-
Gain on disposition of assets held for sale	316,320	-
Rental income	-	67,635
Corporate restructuring	-	(60,740)
Miscellaneous	(47,756)	60,264
	\$ 206,209	\$ 50,692

During the year ended December 31, 2003, the Corporation recorded a gain of \$682,557 from the reversal of unsecured creditor liabilities of a subsidiary.

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**11. Income Taxes**

The amount recorded as a provision for current taxes for the years ended December 31, 2004 and 2003 is in respect of resource taxes, and with respect to 2003 federal large corporations tax, incurred during the year.

The following table reconciles the income and resource taxes that would be incurred by applying statutory tax rates to the Corporation's pre-tax income and the taxes actually recorded:

	<b>2004</b>	<b>2003</b>
Income before provision for taxes	\$ 1,897,210	\$ 922,477
Statutory tax rates	36%	38%
Income taxes at statutory tax rates	682,996	350,541
Non-deductible permanent differences	49,465	(23,719)
Tax benefits not previously recognized	(571,591)	(322,594)
Resource allowance	(160,870)	(4,228)
Resource and large corporations taxes	86,154	48,141
Provision for taxes	\$ 86,154	\$ 48,141

The Corporation has available non-capital losses for income tax purposes of approximately \$3,298,000 (2003 - \$3,185,000), which are available to be carried forward to reduce taxable income in future years, and expire as follows:

2005	\$ 12,000
2006	15,000
2007	1,663,000
2008	4,000
2009	1,026,000
2010	574,000
2014	4,000
	\$ 3,298,000

Net temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases deductible against taxable income of future years, including non-capital losses, total approximately \$56.5 million. The after-tax amount of future income tax assets arising from these temporary differences are summarized as follows:

	<b>2004</b>	<b>2003</b>
Tax loss carry forwards and other amounts	\$ 1,385,017	\$ 1,483,889
Tax values of assets in excess of carrying values	18,379,788	17,084,068
Carrying values of liabilities in excess of tax values	393,443	-
Future income tax assets	20,158,248	18,567,957
Valuation allowance	(20,158,248)	(18,567,957)
	\$ -	\$ -

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**12. Earnings Per Share**

The following table sets forth the computation of basic and diluted earnings per share:

	<b>2004</b>	<b>2003</b>
<b>Numerator</b>		
Net income	\$ 1,811,056	\$ 874,336
<b>Denominator</b>		
Denominator for basic earnings per share – Weighted average number of shares outstanding	31,949,150	29,681,752
Effect of dilutive securities – Stock options	837,264	466,765
Warrants	1,135,135	-
Denominator for diluted earnings per share – Adjusted weighted average number of shares outstanding	33,921,549	30,148,517
<b>Basic earnings per share</b>	<b>\$0.06</b>	<b>\$0.03</b>
<b>Diluted earnings per share</b>	<b>\$0.05</b>	<b>\$0.03</b>

Stock options to acquire 480,000 shares (2003 – 1,141,500 shares) and warrants to acquire 350,000 shares (2003 – 4,499,720 shares) were outstanding at December 31, 2004 but were not included in the computation of diluted earnings per share because their exercise price was greater than the average market price of the Corporation's shares during the year.

**13. Commitments**

The Corporation leases certain equipment and office premises under operating leases. The future minimum payments under these leases are as follows:

2005	\$ 287,592
2006	74,657
2007	17,374
2008	5,853
	<b>\$ 385,476</b>

**14. Contingencies**

In 2002, the Corporation entered into an agreement to acquire a company with certain coal resource properties and equipment. Under the terms of the agreement, the Corporation issued 682,680 shares into escrow pending the satisfaction of certain conditions. Those conditions were not satisfied, and the agreement was terminated. The vendors dispute that the conditions were not or could not be satisfied, and have filed a claim against the Corporation for damages of \$21 million plus certain costs. The shares remain in escrow pending resolution of the claim. The Corporation considers this claim to be without merit and is defending it vigorously. No provision has been recorded in the financial statements in respect of this claim.

**15. Related Party Transactions**

In 2004, a total of \$383,560 (2003 – \$289,447) was paid to two companies which are related to different directors of the Corporation. The payments were made for legal services and for coal trucking and aggregate crushing services.

Other related party transactions are disclosed elsewhere in these financial statements.

**16. FINANCIAL INSTRUMENTS AND CONCENTRATION OF RISK**

**Fair Values**

The Corporation's financial instruments include cash and cash equivalents, marketable securities, receivables, deposits, accounts payable and accrued liabilities and income and resource taxes payable. The fair values of these financial instruments approximate their carrying values.

**Credit Risk**

The Corporation maintains substantially all of its cash and cash equivalents with major financial institutions in Canada and the United States. Financial instruments that potentially subject the Corporation to concentration of credit risk are primarily receivables. Management is of the opinion that any risk of loss is significantly reduced due to the financial strength of the Corporation's major customers.

**Foreign Currency Risk**

A significant component of the Corporation's transactions are undertaken in US dollars, and the company maintains significant deposits in US dollar denominated accounts. Fluctuations in exchange rates between the Canadian and US dollar could have a material effect on the business, results of operations and financial condition of the Corporation. The Corporation may sometimes use derivative instruments to manage its exposure to foreign currency exchange risk. The Corporation had no foreign currency derivatives outstanding at December 31, 2004 or 2003.

**17. Net Change in Non-Cash Working Capital Balances**

The components of the net change in non-cash working capital balances related to operations are as follows:

	<b>2004</b>	<b>2003</b>
Receivables	\$ (804,895)	\$ 67,236
Inventories	2,719,817	(782,701)
Prepaid expenses and deposits	(25,049)	(159,704)
Assets held for sale	62,412	(114)
Accounts payable and accrued liabilities	719,300	(583,565)
Income and resource taxes payable	38,029	(10,624)
Increase (decrease)	\$ 2,709,614	\$ (1,469,472)

**18. Subsequent Events**

As of March 23, 2005, the following significant events have occurred subsequent to December 31, 2004.

**(a) Share Capital**

Subsequent to December 31, 2004, an additional 2,252,500 shares have been issued for total proceeds of \$879,975 upon the exercise of warrants, an additional 585,000 shares have been issued for total proceeds of \$93,950 upon the exercise of stock options and an additional 18,550 shares have been issued for \$22,186 under the employee share purchase plan. Also subsequent

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to December 31, 2004, the Corporation has granted additional options under its stock option plan to acquire a total of 450,000 shares at a prices ranging from \$1.28 to \$1.71.

**(b) Acquisition of Tennessee Mining Assets**

Effective February 10, 2005, the Corporation acquired certain coal leases and mining assets and assumed certain associated liabilities located near Crossville, Tennessee. The assets were acquired from a vendor who formerly operated a surface coal mine on the property, and the Corporation is now commencing the process of bringing an underground coal mine into operation on the property. The assigned values of the assets acquired and liabilities assumed, and the consideration paid, are summarized as follows:

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Assigned values of assets and liabilities assumed:	
Surface mining equipment	\$ 2,685,636
Coal preparation plant and other equipment	2,027,224
Liabilities assumed	(2,153,709)
Permit bonding guarantee assumed	(1,220,275)
	<hr/>
	\$ 1,338,876
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Consideration paid:	
Cash paid	\$ 1,056,379
Fair value of warrants granted	183,000
Costs incurred in completing the acquisition of the assets	99,497
	<hr/>
	\$ 1,338,876

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The assigned values of the surface mining equipment acquired and the liabilities and permit bonding guarantee assumed are their estimated fair values. The in-use value of the coal preparation plant as appraised by a third party and other equipment acquired as estimated by the Corporation is approximately \$3,478,000. However, the Corporation has assigned a carrying value to the coal preparation plant and other equipment of \$2,027,224 given that the value of the consideration paid is less than the value of the assets acquired net of the liabilities assumed.

As part of the consideration paid, the Corporation has issued warrants to acquire 300,000 shares at an exercise price of \$1.77, expiring February 8, 2007. The fair value of these warrants was estimated to be \$183,000. Included in the cash paid was \$339,794 that had been paid as of December 31, 2004 in advance of the acquisition of the assets, and this amount has been included in the Corporation's plant and equipment reported in note 4.

The Corporation has granted a royalty to the vendor of US \$0.50 per short ton of coal sold. A second royalty of US \$0.10 per short ton of coal sold has been granted to a third party, which royalty is extinguished once an aggregate US \$75,000 has been paid under it.

Immediately subsequent to its acquisition by the Corporation, the surface mining equipment was sold to a third party purchaser for proceeds of \$2,685,636, of which \$1,517,554 was immediately applied against certain of the assumed liabilities.

**(c) Acquisition of Northeast British Columbia Resource Properties**

In January 2005, the Corporation entered into a letter of intent to acquire a group of coal resource properties located in Northeast British Columbia near Tumbler Ridge, and in March 2005 the final terms of the transaction were agreed and the acquisition was closed. The group includes 11 properties, eight of which are coking coal properties, two of which are coking and PCI (pulverized coal injection) properties and one of which is a thermal coal property. The consideration to be paid for the properties by the Corporation comprises a mixture of cash and shares, with \$400,000 paid on closing and the remaining consideration paid over time upon the achievement of various

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milestones in the development of the properties. The remaining consideration is summarized as follows:

- (i) With respect to the Five Cabin property, a coking coal property, 800,000 shares upon the preparation of a coal resource estimate report; \$500,000 and 1,000,000 shares upon preparation of a pre-feasibility report; \$500,000 and 1,000,000 shares upon preparation of a feasibility study; and \$1,000,000 and 1,500,000 shares upon commencement of commercial production from the property.
- (ii) With respect to each of seven additional coking coal and PCI properties, shares issuable upon preparation of a coal resource estimate report and upon preparation of a pre-feasibility study in respect of the property, ranging from 4,000 to 5,000 shares per 100,000 tonnes of coal resource identified, with a minimum 10 million tonnes of resource required to trigger consideration payment.
- (iii) For the one thermal coal property, the Corporation must issue 225,000 shares on delivery of a coal resource estimate report and a further 625,000 shares on preparation of a pre-feasibility study, and an additional 1,250 shares for each 100,000 tonnes of resource identified in excess of 20 million tonnes.
- (iv) For one coking coal and PCI property, shares issuable upon preparation of a coal resource estimate report and upon preparation of a pre-feasibility study in respect of the property, ranging from 3,000 to 5,000 shares per 100,000 tonnes of coal resource identified depending on whether the resource is coking coal or PCI or thermal coal, with a minimum 5 million tonnes of resource required to trigger consideration payment.

Various time limits apply within which the Corporation must achieve the set milestones, but the Corporation has the right to extend those time limits on a property by property basis by making certain cash payments. At all times the Corporation has the right to deliver any of the properties back to the vendor, in which case no further consideration or milestone obligations will be owing by the Corporation in respect of such property. All properties are subject to a 1% mine-gate royalty in favour of the vendor.

Upon closing of the acquisition of these properties, the primary vendor has been hired by the Corporation in a senior management capacity.