

07

FORTUNA SILVER MINES INC.
2007 ANNUAL REPORT

INVESTING IN
SILVER
INVESTING IN
GROWTH



FORTUNA
SILVER MINES INC.





San Jose Project
Ag-Au, Developing Project

Caylloma Mine
Ag-Zn-Pb, Operating Mine

Photo: San Jose Underground Ramp

SMALL MOVES. BIG GROWTH.

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Our Vision. Our Mission.	Operating Highlights	President's Letter	Chairman's Letter	Fortuna's Projects	Silver's Run	Financial Statements

All figures expressed in Canadian dollars unless otherwise stated.

This annual report, and the information presented in it, contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. We have tried, whenever possible, to identify these forward-looking statements using words such as "anticipates", "believes", "expects", "plans", "intends", "potential", and similar expressions. These statements reflect our current belief and are based on currently available information. Accordingly, such forward-looking statements involve known and unknown risks, uncertainties and other factors which could cause the Company's actual results, performance or achievements to differ materially from those expressed or implied by such statements. We undertake no obligation to update or advise in the event of any change, addition, or alteration to information presented in this annual report including such forward-looking statements.

Growth, production and silver are key themes to the Fortuna story. Fortuna Silver Mines is progressing quickly towards becoming a mid-tier silver producer. Our Caylloma silver-zinc-lead mine in Peru completed its first full year of operation in 2007 with production rising steadily through the period. At our 76%-owned San Jose silver-gold project in Mexico, high-grade drill results and pre-feasibility work continue to fast-track development towards engineering and construction of a mine and processing plant.

Fortuna has established a focused and aggressive strategy for rapid growth in Peru, Mexico and all of Latin America. Management's extensive experience in Latin American mining, exploration and business development provides a key element in achieving this goal.



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“We promote a stimulating work environment of high-standards and best-practices that fosters respect, teamwork and social and environmental responsibility.”



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01 SIMON RIDGWAY, Chairman of the Board 02 JORGE A. GANOZA DURANT, President, CEO and Director 03 THOMAS I. VEHRs, Vice President, Exploration
 04 JORGE R. GANOZA AICARDI, Vice President, Operations 05 MARK MOSELEY-WILLIAMS, Vice President, Project Development
 06 LUIS DARIO GANOZA DURANT, Chief Financial Officer 07 MANUEL RUIZ-CONEJO CARLOS, Vice President, Business Development

OUR VISION is to build a company valued as a leading silver miner, centered on developing natural resources in Latin America. We operate with a commitment to profitability, growth and high standards, while keeping the well-being of our workers, neighboring communities and the environment foremost in our operations.

OUR MISSION is to maximize shareholder value through the rational acquisition, exploration, development and mining of silver in Latin America with a commitment to sustainable growth of geologic silver resources and annual metal production.

OPERATING HIGHLIGHTS

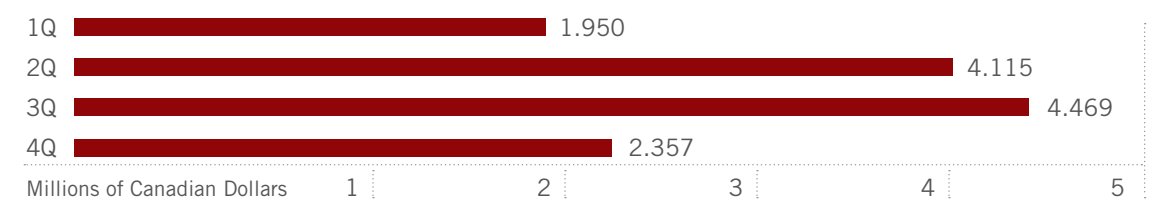
	2007				2007	2006
	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total	Total
Ore Milled (tonnes)	52,687	63,806	65,806	68,615	250,913	33,973
Silver (oz)	95,473	119,110	132,450	139,433	486,466	58,844
Lead (tonnes)	646	952	1,049	1,124	3,771	326
Zinc (tonnes)	1,178	1,605	1,712	1,805	6,300	611
Unit cash production cost (US\$/tonne)	\$42.62	\$56.65	\$49.15	\$52.41	\$48.04	\$38.70
Unit net smelter return (US\$/tonne)	\$90.26	\$123.65	\$133.70	\$118.41	\$117.84	-

FINANCIAL HIGHLIGHTS

	12 mos ended Dec 31, 2007 (000s)	15 mos ended Dec, 2006 (000s)
Sales	\$31,667	3,372
EBITDA*	12,891	-
Income (loss) before income taxes and non-controlling interest	1,380	(3,854)
Net loss	(2,789)	(4,348)
Net loss per share, basic & diluted	(0.04)	(0.12)
Total assets	124,446	59,194

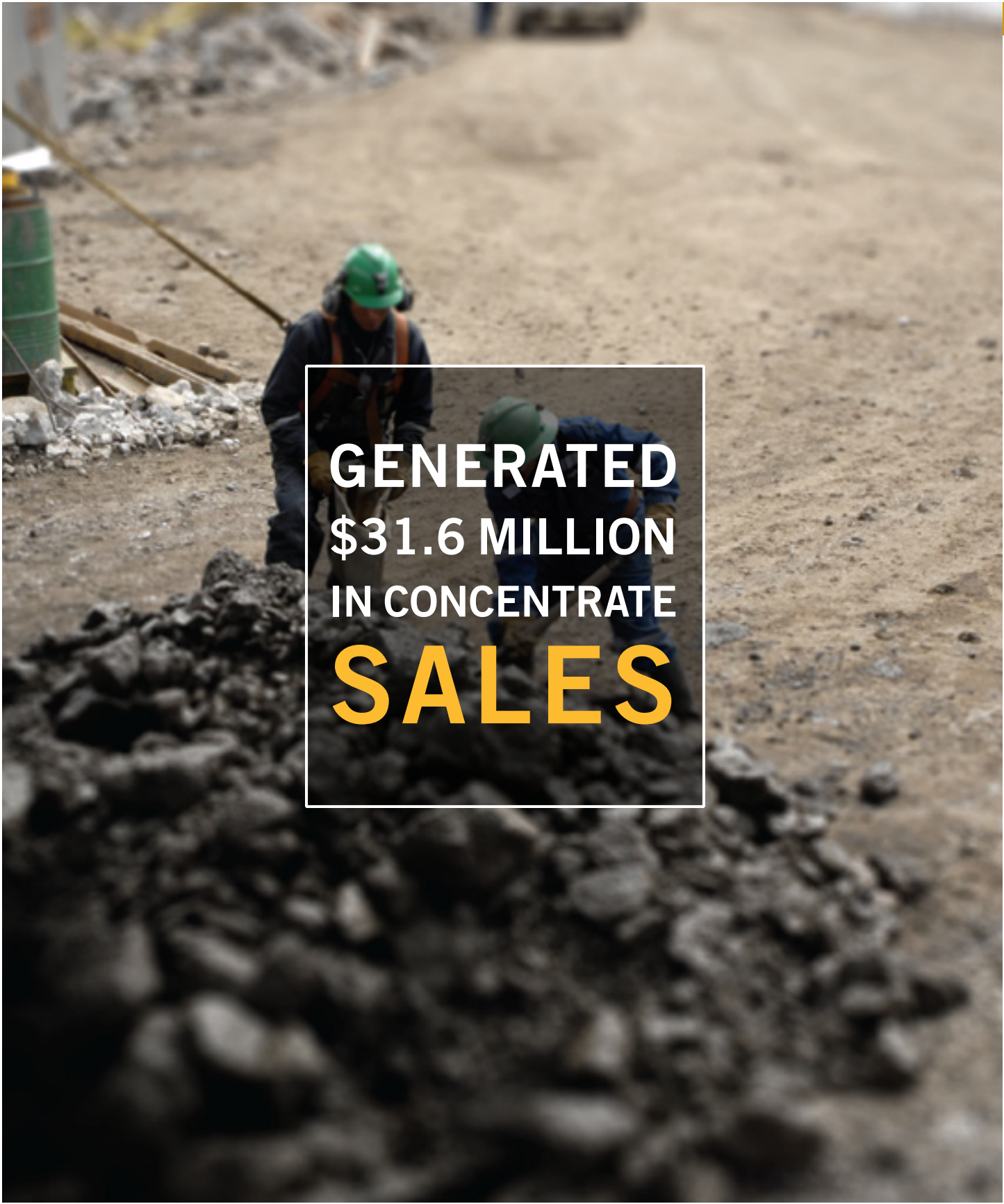
*EBITDA was calculated by adding back to Operating Income < Write-off of deferred exploration costs, stock-based compensation, depreciation, depletion and accretion. >

2007 EBITDA





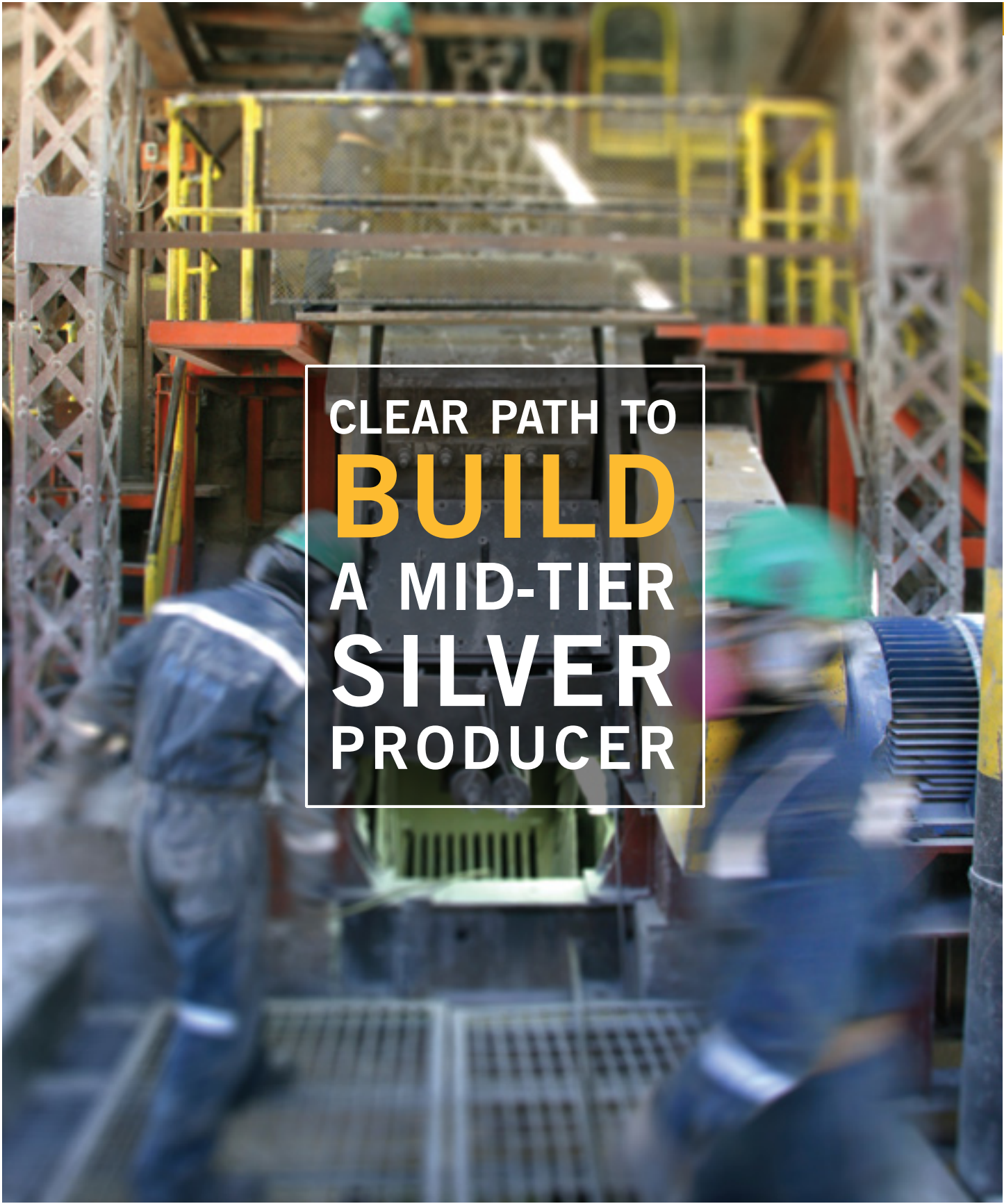
RAISED
\$34.2 MILLION
THROUGH
PRIVATE
PLACEMENT



GENERATED
\$31.6 MILLION
IN CONCENTRATE
SALES



CONSOLIDATED
STRONG
OPERATING TEAMS
AT BOTH SAN JOSE
AND CAYLLOMA



CLEAR PATH TO
BUILD
A MID-TIER
SILVER
PRODUCER

Key Milestones 2007 >

Caylloma

Completed first full year of production

Completed 15,318 meters of exploration drilling

Increased plant throughput from an initial 500 tpd to 950 tpd (June 2008)

With respect to January 2007, Ag – Pb concentrate production increased 176% and Zn concentrate increased 140% (June 2008)

San Jose

Announced five-fold increase in silver equivalent resources in March 2007

Outstanding drill results continued

Underground ramp development of 726 meters (June 2008)

Advancing with mine and plant engineering, hydrologic studies, permitting and long-term community agreements

Key Goals for 2008 >

Caylloma

Increase production to
1050 tpd

Optimization of crushing and
mill circuits

Exploration and development
of high grade silver veins

San Jose

Complete Trinidad area in –
fill drilling

Underground development and
mine design

Metallurgical testing and process
design

Engineering and design of
Infrastructure and services

Establish long-term community
agreements



President's Letter >

"I am extremely pleased to present this report of our achievements in 2007 and our plans for 2008 and beyond. In all key facets of operations, from exploration to production and personnel to funding, we met or exceeded our objectives and your company delivered a year of solid growth. As a result, we enter our next phase of growth in a strong financial and strategic position."

Building a Mid-tier Silver Producer. Fortuna is a young company. We began only three years ago with a vision of building a Mid-tier silver producer in Latin America, focusing on Peru and Mexico, the world's top silver-producing countries. In only a short time, we have acquired two high-quality assets one of which has become a profitable mine.

Funding of \$48 Million in 2007. Financially we have never been stronger. We raised \$34.2 million by way of private placement in January 2007 and warrant conversions added another \$21.06 million. Our funding mix also includes growing cash flow from the Caylloma silver-lead-zinc mine in Peru which achieved its first full year of production in October of 2007. Metal sales reached \$31.6 million during 2007 and net cash flow from operations totaled \$13.24 million. At year-end, we reported a debt-free cash position of \$47.2 million. We are now fully funded to meet near-term objectives and carry out our development plans.



Improving Financial Performance. Our financial performance improved steadily throughout the year, and in the fourth quarter of 2007 we generated net income of \$1.41 million despite lower base metal prices during the period. Overall, we recorded a net loss for the year of \$2.79 million, compared to a loss of \$4.35 million in 2006. Operating income (before interest payments and taxes) was \$0.11 million after deducting \$6.97 million of stock-based compensation charges.

It's important to note that the cash flow generated from Caylloma was invested in mine optimization and expansion. In fact, Caylloma totally self-funded its capital expenditures during the year, a notable achievement for a new mine. We have budgeted another US\$10million for mine improvements and exploration in 2008, all of which will come from internal cash generation. As Caylloma increases production and efficiency, the trend will be towards greater profitability.

Increasing Production. One of our primary goals in 2007 was to increase production at Caylloma throughout the year. We began 2007 at a rate of 500 tonnes per day (tpd), and by December we had reached a rate of 750 tpd. At the time of this report, we were operating at 950 tpd. Silver, lead and zinc production in the fourth quarter increased 46.1%, 53.2% and 74% respectively over the first quarter.

Caylloma is a large project, covering more than 26,000 hectares, but current production comes from only two veins on a very small portion of the concession package. Many intriguing targets require further exploration so part of our operating budget for 2008 is earmarked to explore those areas with the most potential to add to our production.

Outstanding Potential at San Jose. While Caylloma will help Fortuna grow for years to come, we are most excited about the continuing work at our San Jose project in southern Mexico. The project is operated as a joint venture between Fortuna (76%) and Continuum Resources Ltd. (24%). Work carried out to date on the Trinidad Area has defined a significant Ag – Au resource where we have advanced from exploration to in-fill drilling and preliminary engineering, working towards producing a pre-feasibility study. We envision the Trinidad Area will become a significant, long-term producer of silver and gold and we have decided to fast-track permitting and development.

Current Indicated Resources at the Trinidad Area (NI 43 – 101 compliant - see table pg. 29) of the San Jose Project total 17.7 million ounces of silver equivalent, with 49 million ounces of silver equivalent Inferred. In-fill drilling has been carried out in 2007 and will continue through 2008 until Measured and Indicated Resources supporting a pre-feasibility study are achieved.

“Caylloma totally self-funded its capital expenditures during the year, a notable achievement for a new mine.”

San Jose's Rapid Development. We have outlined an aggressive, US\$23 million budget which includes in-fill drilling, engineering and development programs for 2008. Our plan is to secure all permits and complete underground access to the upper 200 meters of mineralization by 2009. Preliminary engineering and in-fill drilling are underway, leading to a pre-feasibility study. We plan to have completed by year end preliminary mine design and site selection for plant facilities, infrastructure and waste/tailings disposal areas. We have also contracted for environmental impact and hydrological studies.

Exploration will continue on the highly prospective 58,000 hectare land package that surrounds the project. Our work in 2008 will include reconnaissance and geological mapping to define new targets.

The Precious Metals Run Continues. At the time of this report, metals prices continued their historic bull run. Silver was trading consistently above US\$16 an ounce with gold well above US\$800. The fundamentals that have driven this market—Asian growth, a weakening U.S. dollar, inflation, and the ongoing silver supply/demand gap—support continued strength for the demand of metals.

Our Most Important Asset. Finally, we cannot realize our vision without strong management and staff. That's why we added many talented people to the Fortuna team during the year, including key positions in mine management, operations, geology/exploration and project and business development. I am incredibly gratified for the way everyone at Fortuna has worked hard at building such a dynamic team. I look forward to reporting continued success throughout the year.



Jorge A. Ganoza Durant,
President, CEO and Director



To Our Shareholders >

A Year of Rapid Growth. We have completed our first full year of production at the Caylloma Mine in Peru. I'm pleased to report that the mine's performance has been better than anticipated, with a profitable operating income of US\$13 million. As we increase production and move into Caylloma's second year of operations, we expect another successful year ahead. At both Caylloma and San Jose, we have reached impressive milestones in a short period. Recent advances in exploration and production indicate we will continue our record of growth in both Peru and Mexico.

Continued Strength in Silver. We have been helped, of course, by unprecedented strength in the metals markets. Our founding business model was to capitalize on expected high prices for silver, along with anticipated strength in gold and base metals. At the same time, we believed the greatest opportunity for new discoveries would be found in Latin America.

Planned Diversity. Our model is proving both resilient and profitable. The price trend for silver appears robust, driven by the same factors driving the gold market—weakness in the U.S. dollar, growing inflation fears and investment purchases. Thus we're experiencing silver prices well above US\$16 per ounce. As the San Jose project comes on stream, we will add considerable gold to our product mix of silver, lead and zinc. This combination will offer some diversity with both precious and base metals, although price trends for all four commodities have remained fairly consistent over the past three years.

Developing San Jose. While Caylloma's production growth is ahead of schedule (with considerable potential for resource expansion), our most important catalyst for growth is clearly San Jose. Exploration in 2007, which included a number of high-grade

drill intersections, indicates San Jose will become an important asset and a significant source of revenue growth for years to come.

Strategy for Continued Growth. Looking ahead, we expect to see our first revenue from San Jose in mid-2010. At that point, with two Latin American mines in operation, we also plan to have identified and acquired several new exploration and/or development projects. While we are focused on Peru and Mexico, we are investigating opportunities in other countries of Central and South America. The great mineral belts of this region transcend boundaries, of course, and there are many vast tracts where exploration has to date been minimal if not non-existent. In addition, we are seeking opportunities to acquire advanced assets and mid-scale, operating mines. Management's knowledge of regional mining, exploration, geology, regulatory environments and business practices will continue to allow Fortuna to identify and acquire opportunities.

Teamwork. High metals prices, great projects and new discoveries have all been essential to our growth, of course, but I believe an equally important ingredient—if not the most important—has been putting together the right team. I wish to thank everyone at Fortuna for their spirit of enterprise and teamwork, and I look forward to even greater accomplishments ahead.



Simon Ridgway,
Chairman



Caylloma Mine

Highlights

- First full year of operation in 2007
- Production ahead of projected levels
- Mine and processing plant optimization
- New resource calculation for 2008
- Budgeted US\$10 million for exploration, development, tailings and plant improvements in 2008
- Over 12,000 hectares of ground to explore

Commodities: Zinc, Lead, Silver & Gold

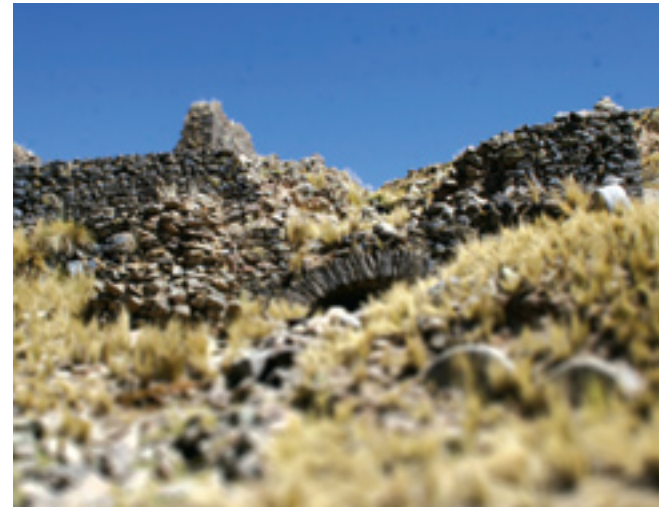
Location: Arequipa, Peru
(Latitude 15° 13" S, Longitude: 71° 49" W)

Ownership: 100% by Fortuna Silver Mines Inc.

Deposit Type: Intermediate-sulfidation epithermal deposit

Status: Mine and processing plant operating at 950 tpd with expansion to 1050 tpd underway.
Actively exploring for new discoveries.

Caylloma Mine >



Overview. Through its wholly-owned Peruvian subsidiary Minera Bateas S.A.C., Fortuna purchased a 100% interest in the past-producing Caylloma Mine and related concessions in 2005. Following significant upgrading and modernization of the processing plant, the mine was returned to production in October of 2006. In 2007, its first full year of operation, Caylloma produced 486,466 ounces of silver, 6,300 tonnes of zinc and 3,771 tonnes of lead from 250,914 tonnes of ore. Higher production is anticipated for 2008.

Fortuna controls over 12,000 hectares encompassing the Caylloma Mining District and nearby Sukuytambo District of southern Peru. The rich epithermal deposits of the Caylloma District have been worked intermittently since the start of the Spanish colonial period in the 1500s, with historical production estimated at over 200 million ounces of silver.

AS OF YEAR-END 2007, MINERAL RESERVES AND RESOURCES AT CAYLLOMA WERE CALCULATED AS FOLLOWS:

Proven & Probable Reserves: 343,046 tonnes @ 454 gpt Ag, 0.8 gpt Au, 0.1% Pb,
0.1% Zn: Contained Ag 5,017,466 oz.

Measured and Indicated Resources: 1,173,326 tonnes @ 143 gpt Ag, 0.7 gpt Au, 4.2% Zn:
Contained Ag 5,426,326 oz.

Inferred Resources: 1,415,499 tonnes @ 305 gpt Ag, 0.4 gpt Au, 2.0% Pb,
3.1% Zn: Contained Ag 13,825,919 oz.

“Through constant optimizations in the processing plant we have been able to surpass our production targets.”

A new updated resource estimate, based on drilling conducted through the year on the Animas vein, is expected during 2008.

Production Higher than Anticipated. Through a continuous optimization process, the plant delivered a greater throughput capacity than the 700 tpd originally contemplated in the first production phase. Production rates increased throughout the period, beginning at 500 tpd and reaching 750 tpd by year end. By June of 2008 the plant was processing 950 tpd. Management anticipates expansion to 1,050 tpd by the end of 2008. Lead+silver and zinc concentrates are delivered weekly to port facilities in nearby Callao for sale on international markets.

Bonanza Grades on the Bateas Vein. Mining is presently concentrated on two principal veins, Animas and Santa Cata. Following discovery of bonanza silver grades on the Bateas vein in 2007, underground development began with a goal of incorporating Bateas mineralization into the production mix for 2008.

Expanding Resources. Exploration of the rich Caylloma district is ongoing with a goal of bringing additional veins into production. More than 15 major mineralized veins have been identified within the district.

We drilled 15,318 meters to test various targets during 2007 and we have budgeted US\$1.7 million for exploration in 2008.



San Jose Project

Highlights

- 17.7 M oz silver equivalent in Measured and Indicated Resources
- 49 M oz silver equivalent in Inferred Resources
- 26,605 meters of drilling in 2007: 17,694 meters of in-fill drilling in Trinidad Area and 8,911 meters of exploratory drilling in the San Ignacio Area
- Budgeted US\$23 million for exploration, in-fill drilling, engineering, design and development in 2008
- Secured surface right agreements for initial 30 hectares

Commodities: Silver & Gold

Location: Oaxaca, Mexico in the Taviche Mining District (Latitude 16° 41" n, Longitude: 96° 42" W)

Ownership: Fortuna Silver Mines Inc. 76%,
Continuum Resources Ltd. 24%

Deposit Type: High-grade, low-sulfidation epithermal deposit

Status: Resources definition, developing project

San Jose Project >

Overview. Located only an hour's drive from the city of Oaxaca, San Jose contains a high-grade silver and gold-bearing system with outstanding exploration potential. Indicated Resources in the property's Trinidad vein system average 262.6 g/t silver and 2.19 g/t gold. The 58,000-hectare land package lies in a silver-gold vein district with a previously unrecognized potential.

San Jose operates under a joint venture between Fortuna (76%) and Continuum Resources Ltd. (24%). Both parties contribute to costs in proportion to their respective ownership percentage.

Engineering and Development in 2008. Based on outstanding drill results achieved in 2006 and 2007, Fortuna's management team decided to accelerate the pace of development of the Trinidad Area. Engineering and design work has begun to build a 1,000 to 1,500 tpd processing plant. The scope of the 2008 program includes:

- In-fill drilling
- Underground development and mine design
- Metallurgical testing and process design
- Infrastructure and services (hydrologic studies, energy, etc.)
- Work on establishing long-term community agreements

We have retained AMEC plc, an international project management and engineering services company, to conduct the Scoping Study. The Scoping and Pre-feasibility studies will include a mine design plan and site selection for plant facilities, mine infrastructure and waste and tailings disposal areas. Underground development has also begun on a 2,000 meter decline main access ramp. At that time of the report, 720 meters of construction had been delivered.

Current NI 43-101 Resources. As of March 31, 2007, mineral resources are estimated as follows (based on drill results from 2006):

Table 1. San Jose Mineral Resource - Cutoff Grade of 150 g/t Silver Equivalent

Resource Classification	K tonnes	Eq Ag (g/t)	Silver (g/t)	Gold (g/t)	Silver (koz)	Gold (koz)
Indicated Mineral Resources:						
- Trinidad Vein	824	322.80	232.20	1.78	6,151.60	47.20
- Bonanza Vein	599	453.30	310.50	2.80	5,979.80	53.90
- Paloma Vein	48	263.80	185.20	1.54	285.80	2.40
Total Indicated Resource	1,471	374.00	262.60	2.19	12,417.20	103.50
Inferred Mineral Resources:						
- Trinidad Vein	1,687	376.70	268.00	2.13	14,536.10	115.50
- Bonanza Vein	1,609	443.60	272.60	3.35	14,102.00	173.30
- Bonanza Splay Vein	15	922.50	694.20	4.48	334.80	2.20
- Paloma Vein	373	275.50	194.30	1.59	2,330.10	19.10
- Stockwork Zone	214	281.60	196.60	1.67	1,352.70	11.50
Total Inferred Resource	3,898	391.50	260.60	2.57	32,655.70	321.50

Indicated Resources contain an estimated 17.7 million silver-equivalent ounces. Inferred Resources are estimated to contain 49.1 million silver-equivalent ounces. Silver equivalency estimates were derived using US\$10.30/oz for silver and US\$525/oz for gold. The resulting Ag:Au ratio is 51:1. Metallurgical recoveries and net smelter returns are assumed to be 100% only for the purposes of estimating silver equivalency.

San Jose Project >

Michael G. Hester of Independent Mining Consultants, Inc. is the Qualified Person for the purposes of reporting of the Mineral Resources as defined by the Canadian Securities Administrators' National Instrument 43-101.

Other Drill Targets on San Jose's 50,000 Hectares Land Package. The San Jose land package contains vast areas of unexplored but very prospective ground. A key part of our work in 2008 includes ongoing generative exploration, including geochemical and geophysical work. Already over 17,000 geochemical soil and stream sediment samples have been collected. So far this work has identified at least four areas of interest that are receiving follow-up detail exploration.

Exploration and Resource Definition In-Fill Drilling. Fortuna completed 26,605 meters of drilling in 2007. In-fill drilling focused on the Trinidad Area (17,694 meters) and San Ignacio Area (8,911 meters).

The 2007 drill program encountered a number of high-grade intersections, including (based on a cutoff grade of 100 g/t silver equivalent):

Drill Hole	From (m)	To (m)	Interval (m)	Au (g/t)	Ag (g/t)	Ag Eq (g/t)	Ag Eq (oz/T)	News Releases
SJO-054	360.70	465.55	104.85	2.48	283	410	12.0	30-May-07
Including	360.70	367.00	6.30	7.00	510	867	25.3	
and	411.25	417.60	6.35	4.52	692	922	26.9	
and	425.30	438.10	12.80	4.58	633	867	25.3	
and	446.00	455.00	9.00	8.32	848	1272	37.1	
SJO-055	173.60	176.10	2.50	11.86	1151	1756	51.2	16-Jul-07
SJO-057	149.90	161.45	11.55	6.06	588	897	26.1	16-Jul-07
SJO-060	129.70	154.80	25.10	10.85	588	1141	33.3	16-Jul-07
including	129.70	135.05	5.35	32.49	2017	3674	107.2	
and	143.60	147.40	3.80	17.61	637	1535	44.8	
SJO-063	292.70	295.30	2.60	4.44	1224	1450	42.3	16-Jul-07
SJO-065	423.50	444.40	20.90	1.43	183	256	7.5	16-Jul-07
SJO-068A	299.5	307.1	7.63	3.7	395	581	17.0	21-Aug-07
SJO-068A	364.8	371.6	6.78	3.9	563	763	22.3	21-Aug-07
SJO-071	164.2	171.2	7.00	1.0	131	182	5.3	21-Aug-07
SJO-074	221.3	222.5	1.25	1.5	758	834	24.3	21-Aug-07
SJO-075	397.97	419.83	21.86	1.6	183	265	7.7	21-Aug-07
SJO-075	432.23	434.50	2.27	2.8	264	407	11.9	21-Aug-07
SJO-079	345.31	346.20	0.89	7.26	867	1237	36.1	5-Sep-07
SJO-079	441.50	475.75	34.25	1.41	143	215	6.3	5-Sep-07
SJO-079	482.45	484.80	2.35	13.60	1039	1733	50.5	5-Sep-07
SJO-081	322.10	347.45	25.35	1.34	113	182	5.4	5-Sep-07
including	345.20	346.35	1.15	9.09	634	1098	32.0	

Silver Market and Uses >

SILVER IN 2007. Industrial and Investment Demand Keep Prices High.

*All prices are in US dollars unless otherwise stated

The average silver price for 2007 rose to \$13.38 per ounce, a 16% increase over 2006 and the fourth straight year of double-digit annual percentage gains. By May of 2008, silver was trading well above \$16.00 per ounce (hitting \$20.80 on March 6) and by late May had exceeded \$18.00.

The primary factors behind silver's climb in 2007 were higher industrial demand and increasing investment purchases. Industrial demand for silver more than offset declines in jewelry, silverware and especially photography. The stronger investment buying held to a trend established over the past decade as buyers finally removed the last of the silver overhang generated during the massive dishoarding in the 1980s. The surge in silver Exchange Traded Funds (ETFs) accelerated this process since the investment vehicles were launched in 2006.

While industrial demand was up 7% from 2006, total world silver demand declined by 2.1%. The sharpest drop by far was from photography, where the 128.3 million ounces used amounted to a 10.9% decrease from the previous year and 45% decrease over the past decade.

What's driving the growth in industrial demand? Silver is the best electrical and thermal conductor of all metals, so it is used widely in electronic and many other industrial/technical applications. As the demand for computers, cell phones, televisions and high-tech uses grows, so does the need for silver as an essential component. That's why industrial demand in 2007 rose the fastest in North America (8.4%), Asia (3.5%) and Europe (3%).

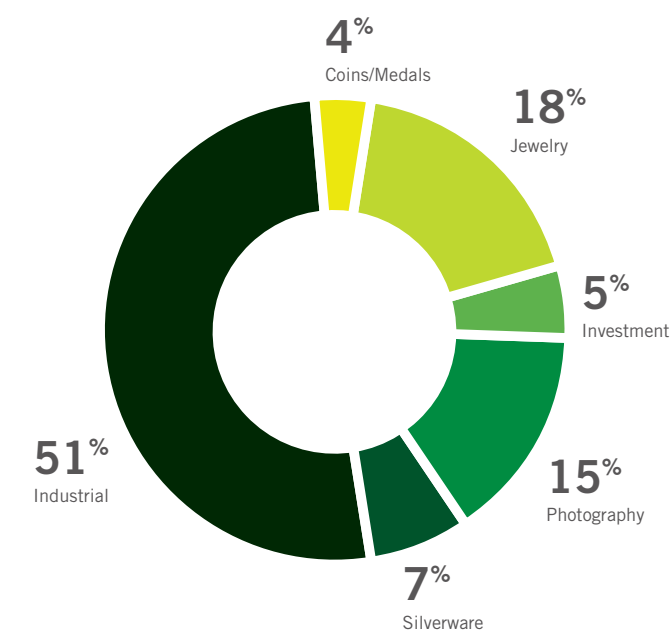
The biggest gains in the supply of silver came from mines, up 3.5% from 2006. As prices remain high, new production will come on stream and continue a trend that has accelerated dramatically in the past decade. Mine production has increased 24% since 1998, more than offsetting declines in government sales and scrap supply.

Despite an expected decline in industrial demand and continued growth in mine supply, the Silver Institute predicts another year of price gains in 2008. The biggest factor in this forecast is further strength in investment demand, fueled mostly by growing inflation fears and US dollar weakness.

WORLD SILVER SUPPLY IN 2007 (MILLION OUNCES)



WORLD SILVER DEMAND IN 2007 (MILLION OUNCES)



Source: The Silver Institute: World Silver Survey 2008



07 Financial Statements

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Year ended December 31, 2007

CHANGE IN FISCAL YEAR END	<p>In August, 2006, Fortuna Silver Mines Inc. ("Fortuna" or the "Company") changed its fiscal year-end from September 30th to December 31st. The Company's year-end now matches that of its Peruvian subsidiary which owns the Caylloma Mine, resulting in an increase in the efficiency of the Company's accounting operations. A Notice of Change in Fiscal Year End was filed on sedar.com.</p> <p>Therefore, the accompanying consolidated financial statements are for the 12 month period ended December 31, 2007, with comparatives to the transitional 15 month period ended December 31, 2006 (further referred to as "2006").</p>
GENERAL	<p>This Management's Discussion and Analysis ("MD&A") should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2007 and fifteen month period ended December 31, 2006, prepared in accordance with Canadian generally accepted accounting principles. This MD&A is prepared as of March 21, 2007. All amounts are expressed in Canadian dollars unless otherwise indicated.</p>
BUSINESS OF THE COMPANY	<p>Fortuna Silver Mines Inc. is a mining company focused on producing silver and developing silver projects in Latin America. The Company's principal assets are the Caylloma poly metallic Mine in southern Peru and the San Jose Silver-Gold Project in southern Mexico.</p>
RECENT DEVELOPMENTS AND 2006 HIGHLIGHTS	<p>Financial and Operating Results</p> <p>In 2007 the Company generated a net loss of \$2.79 million compared to a net loss of \$4.35 million in 2006. For the fourth quarter of 2007 the Company generated a net profit of \$1.41 million compared to \$0.02 million in the corresponding period of 2006. Cash generated by operating activities for 2007 was \$13.24 million compared to cash outflow \$0.78 million in 2006, and \$5.86 million for the fourth quarter of 2007.</p> <p>The Company's Caylloma mine had its first full year of operations in 2007. In the twelve months 250,913 tonnes of ore were treated, and metal production amounted to 486,465 ounces of silver, 6,300 MT of zinc, and 3,771 MT of lead. Cash production cost per tonne for the year was US\$48 and the corresponding unit net smelter return (NSR) was US\$118 (cash production cost is a non-GAAP measure. See page 8 for reconciliation of cash production cost to the cost of sales in the consolidated statement of operations).</p>

San Jose project – resources and project update

On March 12, 2007 Fortuna published an updated resource estimate for San Jose property based on an 11,000 meter drilling program conducted during the first half of 2006. The results significantly exceeded management's expectations, reporting:

Indicated Mineral Resource: 1.47 million tonnes grading 262.6 g/t Ag and 2.19 g/t Au containing 17.7 million Ag equivalent ounces.

Inferred Mineral Resources: 3.9 million tonnes grading 260.6 g/t Ag plus 2.57 g/t Au containing 49.1 million Ag equivalent ounces.

Silver equivalency estimates were derived using US\$10.30/oz for silver and US\$525/oz for gold yielding a Ag:Au ratio of 51:1. Metallurgical recoveries and net smelter returns are assumed to be 100%.

This represented nearly a five fold increase in the inferred resource and the addition of 17.7 million indicated Ag equivalent ounces compared to the previously estimated resource. During 2007, the Company executed a 26,605 meter drilling campaign. Based on this work a new resource estimate is expected to be produced in the second quarter of 2008.

In late 2007 the engineering phase started at San Jose project. The Company expects to conclude its permitting process and a pre-feasibility study in 2008 and based on existing information it plans to go directly into detailed engineering and construction upon conclusion of the pre-feasibility.

Financing

During the past year, the Company was successful in raising significant funding by way of an equity financing; in January 2007 the Company completed a brokered private placement of 18.0 million units at a price of \$1.90 per unit, providing gross proceeds of \$34.20 million. Each unit consists of one common share and one-half of a common share purchase warrant. Each whole warrant entitles the holder to purchase one additional common share of the Company for 18 months at a price of \$2.30.

Management Additions

On October 25, 2007 the Company announced the appointment of Mark Moseley-Williams to the new position of Vice President of Project Development, and on February 6, 2008 the Company announced the appointment Manuel Ruiz-Conejo to the new position of Vice President of Business Development. Mr. Moseley-Williams is based in Oaxaca at the San Jose project site, and Mr. Ruiz Conejo is based out of Fortuna's Lima office.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year End Report – December 31, 2006

SELECTED ANNUAL INFORMATION

		Twelve month period ended Dec. 2007	Fifteen month period ended Dec. 2006
Sales	\$	000	31,667
Income (loss) before income taxes and non-controlling interest	\$	000	1,380
Net loss	\$	000	(2,789)
per share, basic and diluted	\$		(0.04)
Total assets	\$	000	124,446
Total long-term financial liabilities	\$	000	433

QUARTERLY INFORMATION

The following table provides information for the eight fiscal quarters ended December 31, 2007:

		31-12-07	30-09-07	30-06-07	31-03-07	31-12-06	31-09-06	31-09-06	31-03-06
Revenues	\$ 000	7,930	9,201	8,797	5,739	3,370	0	0	0
Net Income (loss)	\$ 000	1,411	(3,391)	947	(1,756)	21	(1,745)	363	(2,371)
Net Income (loss) per share, basic	\$	0.02	(0.05)	0.01	(0.03)	0.00	(0.04)	0.01	(0.09)
Net Income (loss) per share, diluted	\$	0.02	(0.05)	0.01	(0.03)	0.00	(0.04)	0.01	(0.09)

FINANCIAL RESULTS

During 2007 the Company generated \$31.67 million of sales compared to \$3.37 million in 2006. The previous period included only two months of commercial production. During 2007 mine operating income was \$13.11 million and operating income was \$0.11 million after deducting \$6.97 million of stock based compensation charges. These results reflect the healthy margins of the Company's operating Caylloma mine. Operating income attributable to Caylloma for the year was \$8.97 million.

For the last quarter of 2007 the Company recorded record net income of \$1.41 million compared to \$0.02 million in the corresponding quarter of 2006. With respect to previous quarters this increase was achieved in spite of lower zinc prices through increased concentrate sales. The losses of the first and third quarters of 2007 were driven by stock-based compensation charges of \$2.31 million and \$4.12 million respectively.

Total cost of sales for 2007 was \$18.45 million, of which \$5.77 million was depletion, depreciation, and accretion (2006: \$2.18 million and \$0.92 million respectively). This corresponds entirely to production and sales from Caylloma mine.

Year End Report – December 31, 2006

Sales and administrative expenses for 2007 totalled \$6.13 million compared to \$2.03 million for the fifteen months ended December 31, 2006. The increase was largely due to the fact that 2007 was the first full year of operations of Caylloma mine, as well as due to higher total corporate expenses associated to the growth of the company. The stock based compensation charge totalled \$6.97 million for the year ended December 31, 2007, compared to \$4.13 million for the fifteen month period ended December 31, 2006.

Interest and other income and expenses amounted to net income of \$1.53 million compared to net income of \$0.47 million for the fifteen months ended December 31, 2006. In 2007, this amount included \$1.29 million of interest earned, and the increase was due to the Company holding a significantly larger average cash balance for 2007 compared to 2006.

Net gain on commodity contract for 2007 was \$1.56 million and was comprised of a \$0.01 million realized loss on forward lead and zinc contracts entered into with a bank to fix the final settlement price of metal delivered in concentrates, where the final settlement price is yet to be set at a future quotation period according to contract terms, a realized gain of \$0.10 million on lead and zinc derivative contracts (Asian style options) entered into with a bank as part of a medium-term price protection program, and \$1.45 million unrealized gain on derivative positions outstanding at year end associated with the same price protection program.

Interest and finance expenses for 2007 were \$0.09 million compared to \$0.02 million in 2006. These interest expenses relate to short-term loans taken in the last quarter of 2006 and paid off in the first quarter of 2007.

Foreign exchange loss recorded for the year was \$1.67 million, compared to a gain of \$0.67 million for the fifteen months ended December 31, 2006. The Company holds its foreign assets in US and local currencies which have depreciated against the Canadian dollar throughout 2007. Under the temporal method for translation of financial statements which the Company currently uses, the losses arising from the translation to the stronger Canadian dollar are included in the statement of operations.

Write-off of deferred exploration costs was \$0.01 million in 2007 compared to \$0.04 million for the fifteen months ended December 31, 2006. This consisted mainly of regional exploration expenses.

In 2007, the Company recognized a loss on disposal of capital assets of \$0.06 million in connection with disposition of minor equipment at Caylloma mine.

The \$4.26 million Income tax provision recorded in 2007 (2006: \$0.49 million) consisted of current and future income tax expense. Current income tax for the period, including the worker profit sharing plan regulated by Peruvian law was \$0.54 million (2006: nil). Future income tax expense, amounting to \$3.7 million (2006: \$0.49 million) mainly related to temporary differences arising on amounts of mineral properties at Peruvian operations.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year End Report – December 31, 2006

RESULTS OF OPERATIONS**Peru – Caylloma Poly metallic Mine**

Caylloma Mine

	Mar-31	Jun-30	Sep-30	Dec-31	Total
Tonnes milled	52,687	63,806	65,806	68,615	250,913
Grade per tonne					
Silver (oz)	2.23	2.29	2.45	2.43	2.36
Lead (%)	1.39	1.67	1.80	1.87	1.70
Zinc (%)	2.65	2.92	3.01	3.09	2.93
Recoveries					
Silver (%)	71.39	73.28	75.75	77.74	74.75
Lead (%)	88.59	89.22	88.50	87.51	88.43
Zinc (%)	84.16	86.22	86.51	85.09	85.56
Production (metal contained)					
Silver (oz)	95,473	119,110	132,450	139,433	486,466
Lead (tonnes)	646	952	1,049	1,124	3,771
Zinc (tonnes)	1,178	1,605	1,712	1,805	6,300
Unit cash production cost (US\$/tonne)	42.62	46.65	49.15	52.41	48.04
Unit Net Smelter Return (US\$/tonne)	90.26	123.65	133.70	118.41	117.84

The 100% owned Caylloma mine had its first full year of production in 2007 with total ore milled at 250,914 tonnes. The mill started the year at a 500 tpd throughput rate and closed the year at an average monthly rate of 750 tpd. Overall, design parameters like metal recovery and concentrate grades were achieved in a shorter period than originally planned and production ramp up to design capacity was achieved faster than expected. In the fourth quarter of 2007 metal production increases with respect to the first quarter of 2007 for silver, lead, and zinc, were 46.1%, 53.2%, and 74% respectively.

Mine production throughout the year took place principally on the poly metallic Animas vein which provided 76% of ore sourced to the mill in 2007. Other sources of ore were: Santa Cata vein (9%), old stockpiles fed into the mill during the first 5 months of operations (5%), and ore from developments (10%). Head grades also increased steadily throughout the year as expected reflecting the exhaustion of old low grade stockpiles and an increased production from the Animas Central ore shoot, where the Company focused its development and preparation efforts, in line with the 2007 mine plan.

Year End Report – December 31, 2006

Through a continuous optimization process in the crushing and grinding circuit during 2007 the processing plant has delivered a greater throughput capacity than the 700 tpd originally contemplated in the plant design for this first phase of production. Currently the plant is achieving up to 830 tpd. Silver metal recovery in the lead concentrate was taken from an average of 71% for the first quarter of 2007 to 78% in the fourth quarter of 2007, well above the expected 74%. This was achieved by re-circulating the underflow of the lead-silver circuit flotation cells for regrinding with negligible additional investment.

Cash production cost per tonne of treated ore evolved from US\$42.95 for the first quarter of 2007 to US\$52.41 for the fourth quarter of the year, and the average for 2007 was US\$48.46. Out of this unit cash production cost for the year, the increase in 8,910 tonnes of ore stock piles carried in inventory accounts for US\$1.4 and approximately 16,000 tonnes of broken ore held in shrinkage stopes not shown in inventory accounts for approximately another US\$1.0. This accumulation in ore stock took place mainly during the second semester of the year which contributes to the upward trend in unit costs during this period. In particular, during the fourth quarter of 2007 the main driver of the sharp increase in unit costs has been increased mine preparation as the mine is being prepared for higher throughput.

Based on upward cost trends in mine supplies, particularly steel and metallurgical reagents, as well as the expected impact of strong local currency appreciation in the last months of 2007 the Company is expecting cash production costs to remain around US\$50 per tonne for 2008 (cash production cost is a non-GAAP measure. See page 8 for reconciliation of cash production cost to the cost of sales in the consolidated statement of operations).

The processing plant is permitted and practically ready to accommodate production increments up to 1,050 tonnes per day as a yearly average. Management has been accelerating development and preparation of stopes on the Ag-Zn-Pb Animas vein with the objective of achieving full throughput capacity by 2008. During the third quarter of 2007 the Company embarked on an investment plan designed to address infrastructure requirements associated with the expansion at Caylloma, and which consisted mainly of a tailings dam expansion, a main extraction level for the Animas vein, and connection to a new power line for increased energy access. The first two items are well underway, but the energy project is currently delayed due to ongoing negotiations including neighboring mines and the energy company owner of the main power line in the area. As a result of this, a minimum increase to 900 tpd has been planned for 2008, where the timing for full achievement of 1,050 tpd will depend on the resolution of factors currently out of management's control.

A total of 15,318 meters were drilled testing various targets during 2007. The Company is expecting a new updated resource estimate, based on the drilling conducted through the year on the Animas vein, for the second quarter of 2008.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year End Report – December 31, 2006

RESULTS OF OPERATIONS
(continued)

It is important to note the discovery of Bonanza silver grades on the north-east extension of the Bateas vein, as published on a March 10, 2008 news release. Highlights of the drilling on Bateas included 1.6 meters at 6,000 g/t Ag. The Company has initiated the necessary underground development to incorporate Bateas mineralization in the production plan for 2008. The Company has an exploration budget of US\$ 1.7 million and will be drill-testing multiple targets in 2008.

Mexico – San Jose Silver-Gold Project

On March 12, 2007 the Company announced the latest resource estimate for the San Jose project, the details of which are noted above. Subsequent to this, the Company executed a 26,605 meter drilling campaign which concluded on December 2007. 17,694 meters were drilled in the San Jose area and 8,910 meters were drilled on San Ignacio, the southern extension of the mineralized structure, looking to discover a new high grade shoot. The results obtained in the San Jose area have been consistent and were made public through six news releases dated May 30, July 16, August 21, and September 6, 2007, and January 16, and February 21, 2008. Based on these results a new resource estimate is expected during the second quarter of 2008. Drilling conducted in the southernmost San Ignacio area is still pending assay results and an interpretation that will allow follow up work recommendations.

On the greater 40,000 hectare land package a generative exploration program is being conducted. Already over 17,000 geochemical soil and stream sediment samples have been collected. Up to date this exploration work has allowed to delineate 4 areas of interest that are receiving follow up detailed exploration.

During the last quarter of 2007 the Company awarded several studies as part of the engineering phase that has initiated at the project. These include a hydrologic study awarded to Water Management Consultants, the environmental impact study awarded to Clifton Associates Ltd., mill and tailings dam site selection awarded to AMEC, and a scoping study awarded to AMEC as well. A pre-feasibility study, as well as additional metallurgical tests is expected to be awarded early in the second quarter of 2008.

The excavation of an underground ramp commenced at the end of the second quarter of 2007. Up to March 15, 2008, 284 meters of decline had been completed. Poor rock conditions and surface weathering in the initial segment of the ramp have caused a slower advance than the initially projected 170 meters per month. Rock conditions have now normalized. The ramp has been designed based on the existing geologic model and will provide the main access for future underground operations.

The Company expects to conclude its permitting process and the pre-feasibility study in 2008 and based on existing information it plans to go directly into detailed engineering and construction upon conclusion of the pre-feasibility.

Year End Report – December 31, 2006

Acquisitions

Fortuna is constantly evaluating new mining opportunities in order to meet our corporate objective of building significant silver inventory and cash flow, by acquiring advanced projects or operating mines from private parties in Latin America.

Cash cost per tonne (non-GAAP measures)

Cash cost per tonne is a key performance measure that management uses to monitor performance. These performance measures have no meaning within Canadian Generally Accepted Accounting Principles ("Canadian GAAP"), and, therefore, amounts presented may not be comparable to similar data presented by other mining companies.

The following table presents a reconciliation of cash production costs per tonne of processed ore to the cost of sales in the consolidated statement of operations:

	CAD\$ \$'000	US\$ \$'000 @ 0.9308
Cost of sales	18,447	17,170
Change in inventory (ore and concentrate stock piles)	382	355
Depletion, depreciation, and accretion	(5,766)	(5,367)
Total cash production cost	13,063	12,159
Total processed ore (tonnes)		250,914
Cash production cost per tonne of processed ore (US\$)		48.46

LIQUIDITY AND CAPITAL RESOURCES

The Company's cash resources and liquid investments increased during the year ended December 31, 2007 by \$45.60 million to \$47.24 million.

For 2007 operating activities generated a net cash amount of \$13.24 million.

During 2007 the Company invested a total amount of \$10.52 million in mineral properties, where investments in Caylloma and San Jose accounted for \$6.21 million and \$4.31 million respectively. Total amount invested in 2007 in plant and equipment was \$5.80 million, where Caylloma and San Jose accounted for \$2.20 million and \$3.60 million respectively. Additionally, the investments in mining properties and projects in Mexico demanded total value added tax disbursements of \$1.03 million. This value added tax is refundable and is included as part of current assets as at December 31, 2007.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year End Report – December 31, 2006

**LIQUIDITY
AND CAPITAL
RESOURCES**
(continued)

During 2007, Caylloma was successful in self-funding its capital expenditure needs and generating free cash flow. Moving forward management expects ongoing and expansion capital needs for 2008 to continue to be self-financed by internally generated cash from operations. In net terms over the past fiscal year our corporate funding needs were met with the issuance of common shares for total net proceeds of \$55.53 million. This was comprised of \$1.96 million from the exercise of stock options, \$21.06 million from the exercise of warrants, and \$32.51 million of net proceeds from January 2007 private placement.

Also during 2007 the Company paid back short term debt of US\$5.55 million raised in 2006.

With regards to San Jose project, management expects investments of up to US\$19 million over the next 12 months (Fortuna's cost share is 76% of this amount) on advanced engineering and further exploration of the surrounding area. These investments will be funded through internal cash reserves.

As at December 31, 2007, the Company had working capital of \$51.16 million compared to working capital of \$0.11 million at December 31, 2006.

As at March 21, 2008 the Company has 9.68 million warrants outstanding with expiry date of July 11, 2008 and a strike price of \$2.30. The exercise of these warrants could potentially bring in cash to the Company in the amount of \$22.26 million.

Management believes the Company's financial position after the closing of its January financing as well as results of its ongoing operation in Caylloma is sufficient to support the Company's operating and capital requirements on an ongoing basis. Actual funding requirements may vary from those planned due to further acquisition opportunities. Management believes it will be able to raise equity capital or access debt facilities as required in both the short and long term, but recognizes the uncertainty attached thereto.

**RELATED PARTY
TRANSACTIONS**

The Company incurred charges from directors, officers, and companies having a common director or officer as follows:

		Year ended December 31, 2007	15 Months ended December 31, 2006
Mineral property costs – geological fees	\$ 000	45	174
Consulting fees	\$ 000	188	75
Salaries and wages	\$ 000	108	16
Management fees	\$ 000	266	146

These charges were measured at the exchange amount, which is the amount agreed upon by the transacting parties.

Year End Report – December 31, 2006

**CRITICAL
ACCOUNTING
ESTIMATES**

At December 31, 2007, due to related parties consists of \$0.01 million (December 31, 2006 - \$0.03 million) owing to an officer and to companies with a common director. These amounts were incurred as a result of shared administrative costs. These amounts are unsecured, non-interest bearing and payable in the normal course of business.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Significant items subject to such estimates and assumptions include the fair values of financial instruments and derivatives, determination of mineral reserves, the carrying amount of mineral property, plant and equipment, assay grades of metal concentrates sold, valuation of inventories and future income taxes, recoverability of receivables, provisions for asset retirement obligation and reclamation, fair value estimation of acquisitions and stock-based awards. Actual results could differ from those estimates.

**FINANCIAL
INSTRUMENTS**

The carrying value of cash and cash equivalents, receivables, due from/to related parties and accounts payable and accrued liabilities approximate their fair value because of the short-term maturity of those instruments.

The Company enters into derivative contracts to manage its exposure to fluctuations in base metal prices. These contracts are marked-to-market at the end of each period, and the changes in estimated fair value are recorded as an unrealized gain (loss) on commodity contracts in the statement of operations. As at December 31, 2007 the Company estimated the fair value of the outstanding contracts at \$1.47 million, which was recorded as unrealized gain in the consolidated statements of operations, with corresponding derivative asset recognized in the consolidated balance sheet. The estimated fair value was determined based on using applicable valuation techniques for commodity options with reference to the published marked prices for underlying commodities quoted at London Metal Exchange.

The net amount of settled positions in 2007 which were recorded in the statement of operations under net gain on commodity contract was \$0.09 million.

The long-term investments into marketable securities are classified as available-for-sale and are measured at fair value at the end of each period. Fair value of these investments is determined based on published market prices of underlying securities. Change in fair values of available-for-sale marketable securities is recognized in other comprehensive income. During 2007, the Company recorded other comprehensive loss of \$0.05 million relating to change in fair value of marketable securities, which offset other comprehensive gain of \$0.05 million for measurement of these securities at fair value on adoption of financial instrument standards on January 1st, 2007. The amounts are net after tax.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year End Report – December 31, 2006

OTHER DATA

Additional information related to the Company is available for viewing at www.sedar.com.

Share Position and Outstanding Warrants and Options

The Company's outstanding share position at March 21, 2008 is 85,321,659 common shares. In addition, a total of 19,071,779 share purchase warrants and incentive stock options are currently outstanding as follows:

Type of Security	Number	Exercise Price	Expiry Date
Warrants	9,681,424	\$2.30	July 11, 2008
	862,117	\$0.345	June 27, 2010
	1,613,238	\$0.345	November 17, 2010
	12,156,779		
Options	39,000	\$0.37	December 2, 2009
	30,000	\$0.80	July 24, 2010
	250,000	\$2.82	October 9, 2010
	270,000	\$1.35	February 5, 2016
	451,000	\$2.29	March 30, 2016
	60,000	\$1.75	May 8, 2016
	200,000	\$1.75	May 22, 2016
	280,000	\$1.55	July 5, 2016
	860,000	\$1.66	July 10, 2016
	225,000	\$1.61	September 13, 2016
	20,000	\$1.90	November 20, 2016
	50,000	\$1.96	November 23, 2016
	1,385,000	\$2.22	January 11, 2017
	80,000	\$2.75	February 6, 2017
	15,000	\$3.09	April 22, 2017
	50,000	\$3.10	May 31, 2017
	50,000	\$3.10	June 17, 2017
	50,000	\$3.05	June 27, 2017
	2,025,000	\$3.22	July 2, 2017
	250,000	\$2.97	September 23, 2017
25,000	\$3.10	October 24, 2017	
250,000	\$2.52	February 5, 2018	
	6,915,000		

Year End Report – December 31, 2006

CHANGE IN ACCOUNTING POLICY

On January 1, 2007, the Company adopted the provisions of CICA Sections 1530 "Comprehensive Income", 3251 "Equity", 3855 "Financial Instruments – Recognition and Measurement", 3861 "Financial Instruments – Presentation and Disclosure", and 3865 "Hedges". These sections address the classification, recognition and measurement of financial instruments and hedges in the financial statements and inclusion of other comprehensive income.

Comprehensive income is the change in the net assets of a company arising from transactions, events and circumstances not related to shareholders. It consists of net income and other comprehensive income, which includes items that would not normally be included in net income such as unrealized gains and losses on available-for-sale securities.

As a result of adopting these new standards at January 1, 2007, the Company recorded an unrealized gain of \$0.45 million relating to the change in accounting for financial assets classified as "available-for-sale". As a result of change in accounting policy, these financial assets are measured at fair value instead of cost. This increase was reported as a one-time cumulative effect to other comprehensive income.

Additional detail relating to changes in accounting policy with regards to financial instruments can be found in Note 4 of the consolidated financial statements as at and for the twelve months ended December 31, 2007.

FORWARD LOOKING INFORMATION

Certain statements contained in this MD&A and elsewhere constitute forward-looking statements. Such forward-looking statements involve a number of known and unknown risks, uncertainties and other factors which may cause the actual results, and performance of achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date the statements were made, and readers are advised to consider such forward-looking statements in light of the risks set forth below.

RISKS AND UNCERTAINTIES

The most significant risk affecting the profitability and viability of the Company's mining operations is the fluctuation of metal prices. Volatility of metal prices is high by historic measures and strong downturns on these prices can have significant adverse effects on the continuity of the Company's operations. In order to mitigate this risk in the medium term, the Company has put in place price protection strategies for approximately 50% of its zinc and lead metal production during twelve months from the original contract dates up to January 2009.

The Company's reporting currency is the Canadian dollar, however the Company's foreign assets as well as most of its commercial transactions are held and take place in US and local currencies. As a consequence, the financial results of the Company's operations as reported in Canadian dollars are subject to changes in value of the Canadian dollar relative to US and local currencies.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year End Report – December 31, 2006

RISKS AND UNCERTAINTIES

The business of mineral exploration and extraction involves a high degree of risk. Few properties that are in the exploration stage ultimately become producing mines. The Company's mineral properties are located in emerging nations and consequently may be subject to a higher level of risk compared to developed countries. Operations, the status of mineral property rights, title to the properties and the recoverability of amounts shown for mineral properties in emerging nations can be affected by changing economic, regulatory, and political situations.

INTERNAL DISCLOSURE CONTROLS AND PROCEDURES

The Company evaluated the effectiveness of the design and operation of the disclosure controls and procedures as of December 31, 2007 under the supervision of the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO"). Based on the results of this evaluation the CEO and the CFO have concluded that such disclosure controls are sufficiently effective to provide reasonable assurance that material information relating to the Company is made known to management and disclosed in accordance with the applicable securities laws.

Management is responsible for establishing a system of internal control over financial reporting to provide reasonable assurance regarding the reliability and integrity of the Company's financial information and the preparation of its financial statements in accordance with Canadian generally accepted accounting principles. Management of the Company has evaluated design of internal control over financial reporting as of December 31, 2007 and has concluded there are no material weaknesses. Management continues to review and refine its internal controls and procedures.

In 2006 the Company reported material weaknesses in the design of internal control over financial reporting. Throughout 2007 management has addressed this by ensuring adequate advice on Canadian GAAP is available to account for complex transactions.



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AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheet of Fortuna Silver Mines Inc. as at December 31, 2007 and 2006 and the consolidated statements of operations and comprehensive loss, shareholders' equity and cash flows for the year ended December 31, 2007 and the fifteen month period ended December 31, 2006. 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 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, 2007 and 2006 and the results of its operations and its cash flows for the year ended December 31, 2007 and the fifteen month period ended December 31, 2006 in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants
Vancouver, Canada
March 20, 2008

KPMG LLP, a Canadian limited liability partnership is the Canadian member firm of KPMG International, a Swiss cooperative.

FORTUNA SILVER MINES INC.

(Formerly Fortuna Ventures Inc.)

DECEMBER 31, 2007 AND DECEMBER 31, 2006

Expressed in thousands of Canadian Dollars

**CONSOLIDATED
BALANCE SHEETS**

	Dec. 31, 2007	Dec. 31, 2006
ASSETS		
CURRENT		
Cash and cash equivalents	\$ 47,240	\$ 1,641
Derivatives (Note 5)	1,400	-
Accounts receivable and prepaid expenses (Note 6)	2,051	1,901
GST and value added taxes	5,147	3,738
Inventories (Note 7)	1,693	826
	57,531	8,106
LONG-TERM INVESTMENTS (Note 8)	908	741
PROPERTY, PLANT & EQUIPMENT (Note 9)	13,669	7,806
MINERAL PROPERTIES (Note 10)	52,338	42,541
	\$ 124,446	\$ 59,194
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	\$ 5,917	\$ 2,193
Due to related parties, net (Note 11)	14	27
Current portion of obligation under capital lease (Note 12)	439	45
Loans (Note 12)	-	5,730
	6,370	7,995
OBLIGATIONS UNDER CAPITAL LEASE (Note 12)	433	97
ASSET RETIREMENT OBLIGATION (Note 13)	1,916	1,758
FUTURE INCOME TAX LIABILITY (Note 14)	8,069	4,910
NON-CONTROLLING INTEREST (Note 10)	6,593	3,227
	23,381	17,987
SHAREHOLDERS' EQUITY		
SHARE CAPITAL (Note 15)	100,159	43,341
CONTRIBUTED SURPLUS	11,770	6,085
DEFICIT	(11,008)	(8,219)
ACCUMULATED OTHER COMPREHENSIVE INCOME (Note 16)	144	-
	101,065	41,207
	\$ 124,446	\$ 59,194

Nature and continuance of operations (Note 1)

Commitments (Note 19)

Subsequent events (Note 20)

APPROVED BY THE DIRECTORS:


 Jorge Ganoza Durant,
 Director


 Simon Ridgway,
 Director
FORTUNA SILVER MINES INC.

(Formerly Fortuna Ventures Inc.)

FOR THE YEAR ENDED DECEMBER 31, 2007 AND
FOR THE FIFTEEN MONTH PERIOD ENDED DECEMBER 31, 2006

Expressed in thousands of Canadian Dollars, except for share and per share amounts

**CONSOLIDATED
STATEMENTS OF
OPERATIONS AND
COMPREHENSIVE
LOSS**

	Year ended Dec. 31, 2007	15 month period ended Dec. 31, 2006
Sales	\$ 31,667	\$ 3,372
Cost of sales (including depletion, depreciation and accretion of \$5,766 and \$919)	18,447	2,175
MINE OPERATING INCOME	13,220	1,197
Selling, general and administrative expenses (includes depreciation of \$32 and \$0)	6,127	2,025
Stock-based compensation (Note 15)	6,974	4,132
Write-off of deferred exploration costs	12	40
	13,113	6,197
OPERATING INCOME (LOSS)	107	(5,000)
Interest and other income and expenses	1,529	470
Interest and finance expenses	(90)	(23)
Net gain on commodity contracts (Note 5)	1,558	-
Loss on disposal of property, plant and equipment	(59)	-
Gain on disposal of investment	-	26
Foreign exchange (loss) gain	(1,665)	673
	1,273	1,146
INCOME (LOSS) BEFORE INCOME TAXES AND NON-CONTROLLING INTEREST	1,380	(3,854)
Income tax provision (Note 14)	4,261	494
Non-controlling interest	(92)	-
NET LOSS FOR THE PERIOD	\$ (2,789)	\$ (4,348)
Other comprehensive loss, net of tax Unrealized loss on available for sale long-term investments (Note 8)	(305)	-
COMPREHENSIVE LOSS FOR THE PERIOD	(3,094)	(4,348)
Loss per share - Basic and diluted	\$ (0.04)	\$ (0.12)
Comprehensive loss per share - Basic and diluted	\$ (0.04)	\$ (0.12)
Weighted average number of shares outstanding	71,602,275	36,834,106

FORTUNA SILVER MINES INC.

(Formerly Fortuna Ventures Inc.)

FOR THE YEAR ENDED DECEMBER 31, 2007

AND FOR THE FIFTEEN MONTH PERIOD ENDED DECEMBER 31, 2006

Expressed in thousands of Canadian Dollars, except for share amounts

**CONSOLIDATED
STATEMENTS OF
SHAREHOLDERS'
EQUITY**

	Share Capital		Share subscriptions and obligation to issue shares and warrants	Contributed surplus	(Deficit)	Total Shareholders' Equity
	Shares	Amount				
Balance – September 30, 2005	20,083,465	\$ 12,164	\$ 6,616	\$ 296	\$ (3,871)	\$ 15,205
Exercise of options	650,000	424	-	-	-	424
Exercise of warrants	6,124,631	5,601	-	-	-	5,601
Private placement for cash	16,700,000	22,050	(2,031)	-	-	20,019
Private placement commission non-cash transaction	760,261	1,140	-	-	-	1,140
Private placement acquisition non-cash transaction	1,897,621	2,714	(2,714)	-	-	-
Fair value of share purchase warrants issued	-	-	(1,871)	1,871	-	-
Property finders fee non-cash transaction	50,000	68	-	-	-	68
Property acquisition non-cash transaction	168,417	285	-	-	-	285
Loan fee	153,333	276	-	-	-	276
Transfer of contributed surplus on exercise of options	-	214	-	(214)	-	-
Stock based compensation	-	-	-	4,132	-	4,132
Issue costs (non-cash amount \$1,140)	-	(1,595)	-	-	-	(1,595)
(Loss) for the period	-	-	-	-	(4,348)	(4,348)
Balance December 31, 2006	46,587,728	\$ 43,341	\$ -	\$ 6,085	\$ (8,219)	\$ 41,207

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FOR THE YEAR ENDED DECEMBER 31, 2007

AND FOR THE FIFTEEN MONTH PERIOD ENDED DECEMBER 31, 2006

Expressed in thousands of Canadian Dollars, except for share amounts

**CONSOLIDATED
STATEMENTS OF
SHAREHOLDERS'
EQUITY**

	Share Capital		Contributed Surplus	(Deficit)	Accumulated other Comprehensive Income	Total Shareholders' Equity
	Shares	Amount				
Balance – December 31, 2006	46,587,728	\$ 43,341	\$ 6,085	\$ (8,219)	\$ -	\$ 41,207
Cumulative impact of accounting changes, net of tax (Note 4)	-	-	-	-	449	449
Exercise of options	1,753,600	1,957	-	-	-	1,957
Exercise of warrants	14,214,035	21,057	-	-	-	21,057
Private placement for cash	18,000,000	34,200	-	-	-	34,200
Private placement commission non-cash transaction	422,300	802	-	-	-	802
Transfer of contributed surplus on exercise of options	-	1,289	(1,289)	-	-	-
Stock based compensation	-	-	6,974	-	-	6,974
Issue costs (non-cash amount \$802)	-	(2,487)	-	-	-	(2,487)
(Loss) for the period	-	-	-	(2,789)	-	(2,789)
Other comprehensive (loss), net of tax	-	-	-	-	(305)	(305)
Balance December 31, 2007	80,977,663	\$ 100,159	\$ 11,770	\$ (11,008)	\$ 144	\$ 101,065

FORTUNA SILVER MINES INC.

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FOR THE YEAR ENDED DECEMBER 31, 2007 AND

FOR THE FIFTEEN MONTH PERIOD ENDED DECEMBER 31, 2006

Expressed in thousands of Canadian Dollars

**CONSOLIDATED
STATEMENTS OF
CASH FLOWS**

	Year ended Dec. 31, 2007	15 month period ended Dec. 31, 2006
OPERATING ACTIVITIES		
Net (loss) for the period	\$ (2,789)	\$ (4,348)
Items not involving cash		
Depletion and depreciation	5,640	739
Accretion expense	158	180
Future income tax	3,717	494
Stock based compensation	6,974	4,132
Unrealized (gain) on commodity contracts	(1,466)	-
Non-controlling interest	(92)	-
Write-off of deferred exploration costs	12	40
(Gain) on disposal of investment	-	(26)
Loss on disposal of equipment	59	-
Foreign exchange (gain)	(515)	(272)
Changes in non-cash working capital items		
Accounts receivable and prepaid expenses	(527)	(2,256)
Inventories	(798)	(826)
Accounts payable	2,877	1,367
Payments (to) from related parties (Note 11)	(13)	19
Net cash from (used in) operating activities	13,237	(757)
FINANCING ACTIVITIES		
Proceeds on issuance of common shares	55,528	25,589
Capital lease obligations	(132)	(29)
Repayment of debt (Note 12)	(5,730)	(5,070)
Proceeds from loans	-	5,685
Net cash from financing activities	49,666	26,175
INVESTING ACTIVITIES		
Purchase of long-term investment	-	(1,000)
Mineral property expenditures	(10,515)	(20,657)
Value added taxes on purchase of property, plant and equipment	(1,033)	(3,302)
Property, plant & equipment expenditures	(5,795)	(4,668)
Proceeds from disposal of equipment	39	-
Net cash used in investing activities	(17,304)	(29,627)
INCREASE (DECREASE) IN CASH	45,599	(4,209)
Cash and cash equivalents – beginning of period	1,641	5,850
CASH AND CASH EQUIVALENTS – END OF PERIOD	\$ 47,240	\$ 1,641
Supplementary disclosure of cash flow information:		
Cash (received) paid for interest	\$ (1,504)	\$ 84
Cash paid for income taxes	\$ 608	\$ -
Non-cash transactions (Note 18)		

FORTUNA SILVER MINES INC.

(Formerly Fortuna Ventures Inc.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Expressed in thousands of Canadian Dollars, except for share and per share amounts

**01. NATURE AND
CONTINUANCE OF
OPERATIONS**

Fortuna Silver Mines Inc. (the "Company") is engaged in silver mining and related activities, including exploration, extraction, and processing. The Company operates the Caylloma zinc/lead/silver mine in southern Peru and is currently developing the San Jose silver/gold project in Mexico.

The Company's continuing operations and the recoverability of amounts shown for its exploration stage mineral properties are dependent upon the availability of the necessary financing to complete the exploration and development of such mineral property interests, and upon future profitable production or proceeds from the disposition of its mineral property interests. Future profitable production is primarily dependent on the quality of ore resources, ability to obtain permits, future metal prices, operating and environmental costs, fluctuations in currency exchange rates, political risks and varying levels of taxation.

**02. SIGNIFICANT
ACCOUNTING
POLICIES**

In 2006, the Company changed its year-end from September 30 to December 31. The comparative figures reflect the 15 month period ended December 31, 2006.

a) Basis of presentation:

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). The consolidated financial statements include the accounts of the Company's wholly owned subsidiaries, Minera Bateas SAC (Bateas) and Fortuna Silver (Barbados) Inc. and of the Company's 76% interest in Compania Minera Cuzcatlan SA, a variable interest entity for which a non-controlling interest has been recorded to reflect the 24% interest of the Company's partner. All significant intercompany balances and transactions have been eliminated on consolidation.

b) Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Significant items subject to such estimates and assumptions include the fair values of financial instruments and derivatives, determination of mineral reserves, the carrying amount of mineral property, plant and equipment, assay grades of metal concentrates sold, valuation of inventories and future income taxes, recoverability of receivables, provisions for asset retirement obligation and reclamation, fair value estimation of acquisitions and stock-based awards. Actual results could differ from those estimates.

c) Revenue Recognition:

Revenue arising from the sale of metal concentrates is recognized when title and the significant risks and rewards of ownership of the concentrates have been transferred to the buyer. The passing of title to the customer is based on the terms of the sales contract and final commodity prices are set on a specified quotational period, either one or three months after delivery at the option of the customer. The Company's metal concentrates are provisionally priced at the time of sale based on the prevailing market price.

d) Cash and cash equivalents

Cash and cash equivalents include highly liquid investments with original maturities of ninety days or less.

FORTUNA SILVER MINES INC.

(Formerly Fortuna Ventures Inc.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Expressed in thousands of Canadian Dollars, except for share and per share amounts

e) Long-term investments

Long-term investments are those investments which the Company will be retaining for a period longer than one year. These investments are classified as available-for-sale and are recorded at fair value.

f) Property, Plant and Equipment

Property, plant and equipment are recorded at cost and are depreciated over the estimated economic life of the asset as follows:

Buildings, mine site	Life of mine
Buildings, other	20 – 30 years
Machinery and equipment	3 – 8 years
Furniture and other equipment	4 – 10 years
Vehicles	4 – 5 years

The expected remaining life of the mine as at December 31, 2007 is 9 years. Land is not depreciated. Equipment under capital lease is initially recorded at the present value of minimum lease payments at the inception of the lease.

Management reviews the carrying value of its property, plant, and equipment when events or changes in circumstances indicate that their carrying values may not be recoverable. Impairment of an asset is considered to exist if total estimated future cash flows on an undiscounted basis expected to be generated by the asset are less than the carrying amount of the asset. If a shortfall exists, the asset is written down to its fair value.

g) Mineral Properties

The Company defers the cost of acquiring, maintaining its interest, exploring and developing mineral properties when future inflow of economic benefits from the properties is probable and until such time as the properties are placed into production, abandoned, sold or considered to be impaired in value. Costs of producing properties, including capitalized interest are amortized on a unit-of-production basis over proven and probable reserves and costs of abandoned properties are written-off. Proceeds received from the sale of interests in mineral properties are credited to the carrying value of the mineral properties, with any excess included in operations. Write-downs due to impairment in value are charged to operations.

For operating mines all replacement and expansion exploration within the mineral deposit is capitalized and amortized on a unit-of-production basis over proven and probable reserves as part of the production cost.

Management reviews the carrying value of mineral properties when events or changes in circumstances indicate that their carrying values may not be recoverable. Amounts shown for properties represent costs incurred net of write-downs and recoveries, and are not intended to represent present or future values.

FORTUNA SILVER MINES INC.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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**02. SIGNIFICANT
ACCOUNTING
POLICIES
(continued)****h) Asset Retirement Obligation**

The fair value of an obligation associated with the retirement of a tangible long-lived asset is recorded in the period in which it is incurred and a reasonable estimate of the fair value can be made, with a corresponding increase to the carrying amount of the related asset. The liability is accreted over time for changes in the fair value of the liability through charges to accretion, which is included in depletion, depreciation and accretion expense. The costs capitalized to the related assets are amortized in a manner consistent with the depletion and depreciation of the related assets.

i) Inventories

Ore stockpile and finished goods inventories are valued at the lower of production cost and net realizable value. Production costs include all mine site costs. Materials and supplies are valued at weighted average cost less allowances for obsolescence.

j) Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to 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 year that includes the date of substantive enactment. Future tax assets are recognized to the extent that they are considered more likely than not to be realized.

k) Stock-based Compensation

The Company has a share option plan which is described in Note 15. The Company records all stock-based compensation relating to options granted using the fair value method such that stock-based payments are measured at fair value and expensed over their vesting period with a corresponding increase to contributed surplus. Upon exercise of share purchase options, the consideration paid by the option holder, together with the amount previously recognized in contributed surplus, is recorded as an increase to share capital.

l) Basic and Diluted Loss Per Share

Basic loss per share ("LPS") is calculated by dividing the net loss applicable to common shareholders by the weighted average number of common shares outstanding for the year. Potentially dilutive outstanding options and warrants are excluded from the calculation of LPS, as they would be anti-dilutive.

m) Foreign Currency Translation

The Company's subsidiaries are accounted for as integrated foreign operations. Monetary items denominated in a foreign currency are translated into Canadian dollars at exchange rates prevailing at the balance sheet date and non-monetary items are translated at exchange rates prevailing when the assets were acquired or obligations incurred. Foreign currency denominated revenue and expense items are translated at the exchange rates prevailing at the transaction date. Gains or losses arising from the translations are included in operations except for gains or losses arising from translation of capitalized costs and costs of purchase of property, plant and equipment at exploration properties, in which case such foreign exchange gains or losses are capitalized.

FORTUNA SILVER MINES INC.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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n) Financial Instruments

The long-term investments are classified as available-for-sale and are recorded at their fair value, which is determined with reference to market value of underlying marketable securities. Derivative instruments are recorded at fair value, which is determined with reference to the market value of underlying commodities. All other financial instruments are recorded at cost, which approximates their fair value, due to the short-term maturity and high liquidity.

o) Risk Management*Interest rate risk*

The Company holds cash and cash equivalents which earn interest at variable rates as determined by financial institutions.

Credit risk

The Company only places its cash with major financial institutions.

Foreign currency risk

The Company is exposed to currency risk in that its subsidiary operations are transacted in Peruvian Nuevo Soles, Mexican Pesos and the U.S. dollar. The Canadian dollar value of the assets and liabilities of the subsidiary denominated in these three currencies will fluctuate due to changes in foreign exchange. The Company does not use any hedging instruments to reduce its foreign currency exposure.

Canadian Institute of Chartered Accountants ("CICA") has issued three new standards which will affect the financial disclosures and results of operations of the Company for interim and annual periods beginning January 1, 2008. The company will adopt the requirements commencing in the interim period ended March 31, 2008. The adoption of these new standards is not expected to have any material impact on the Company's financial results.

a) Section 1535 – Capital Disclosures

This Section establishes standards for disclosing information about an entity's capital and how it is managed. Under this standard the Company will be required to disclose the following, based on the information provided internally to the entity's key management personnel:

- (i) qualitative information about its objectives, policies and processes for managing capital;
- (ii) summary quantitative data about what it manages as capital;
- (iii) whether during the period it complied with any externally imposed capital requirements to which it is subject; and
- (iv) when the company has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

b) Section 3031 - Inventories

This Section prescribes the accounting treatment for inventories and provides guidance on the determination of costs and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

**03. NEW
ACCOUNTING
PRONOUNCEMENTS****FORTUNA SILVER MINES INC.**

(Formerly Fortuna Ventures Inc.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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c) Section 3862 – Financial Instruments – Disclosures

This Section replaces Section 3861 "Financial Instruments – Disclosure and Presentation" and requires entities to provide disclosure of quantitative and qualitative information in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance; and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and management's objectives, policies and procedures for managing such risks. Entities will be required to disclose the measurement basis or bases used, and the criteria used to determine classification for different types of instruments.

The Section requires specific disclosures to be made, including the criteria for:

- (i) designating financial assets and liabilities as held for trading;
- (ii) designating financial assets as available-for-sale; and
- (iii) determining when impairment is recorded against the related financial asset or when an allowance account is used.

**04. FAIR VALUE OF
FINANCIAL
INSTRUMENTS****Adoption of New Accounting Standards**

On January 1, 2007, the Company adopted the provisions of the Canadian Institute of Chartered Accountants Handbook ("CICA HB") Sections 1530 "Comprehensive Income", 3251 "Equity", 3855 "Financial Instruments – Recognition and Measurement", 3861 "Financial Instruments – Presentation and Disclosure", and 3865 "Hedges". These sections address the classification, recognition and measurement of financial instruments and hedges in the financial statements and inclusion of other comprehensive income. These standards have been applied retrospectively with no restatement of comparative amounts for prior periods.

a) Comprehensive income

Section 1530 introduces comprehensive income, which consists of net income and other comprehensive income. Other comprehensive income represents changes in shareholders' equity during a period arising from transactions and other events and circumstances from non-owner sources and includes unrealized gains and losses on financial assets classified as available-for-sale. The components of comprehensive income are disclosed on the consolidated statements of operations and comprehensive loss.

b) Financial instruments

Financial assets and liabilities held-for-trading are measured at fair value with changes in those fair values recognized in net income. Financial assets and financial liabilities considered held-to-maturity, loans and receivables, and other financial liabilities are measured at amortized costs using the effective interest method of amortization. Available-for-sale financial assets are measured at fair value with unrealized gains and losses recognized in other comprehensive income. Investments in equity instruments classified as available-for-sale that do not have a quoted market price in an active market are measured at cost.

Derivative instruments, including embedded derivatives, are recorded on the balance sheet at fair value. Changes in the fair values of derivative instruments are recognized in net income with the exception of derivatives designated as effective cash flow hedges. Section 3865 establishes the standards for hedge accounting.

FORTUNA SILVER MINES INC.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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c) Impact upon adoption of CICA HB Section 1530, 3251, 3855, 3861 and 3865

As a result of adopting these new standards at January 1, 2007, the Company recorded an unrealized gain of \$449 resulting from the change in accounting for financial assets classified as "available-for-sale". Prior to adoption of these new standards these financial assets were stated at cost. The gain was recorded as a one-time cumulative adjustment to other comprehensive income (Note 16).

05. DERIVATIVES

During October 2007, the Company entered into a series of put and call option commodity arrangements to secure a minimum price level on part of its zinc and lead metal production throughout the period November 2007 to December 2008. A long put and a long call refer to put and call options that have been bought by the Company, and a short call refers to call options that have been sold by the Company. Settlement of these options occurs monthly during the period from December 2007 until January 2009. No initial premium associated with these trades has been paid.

The following Zinc Asian Option contracts were entered into:

14 Long put options at strike price:	USD 2,575/t, for the total of 2,800 tons
14 Short call options at strike price:	USD 2,750/t, for the total of 2,800 tons
14 Long call options at strike price:	USD 3,450/t, for the total of 2,800 tons

The following Lead Asian Option contracts were entered into:

14 Long put options at strike price:	USD 3,000/t, for the total of 1,750 tons
14 Short call options at strike price:	USD 3,300/t, for the total of 1,750 tons
14 Long call options at strike price:	USD 4,300/t, for the total of 1,750 tons

As at December 31, 2007 the Company had 12 open options on each of the arrangements. The estimated fair value of the outstanding Asian Options of \$1,400 was determined based on using applicable valuation techniques for commodity options with reference to the published market prices for underlying commodities quoted at London Metal Exchange. This amount has been recorded as an unrealized gain on commodity contract as at December 31, 2007.

06. ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31, 2007	December 31, 2006
Trade accounts receivable	\$ 409	\$ 1,562
Advances and other receivables	1,505	279
Prepaid expenses and deposits	137	60
	\$ 2,051	\$ 1,901

07. INVENTORIES

Inventories consist of the following:

	December 31, 2007	December 31, 2006
Ore stock piles	\$ 466	\$ 78
Concentrate stock piles	159	165
Materials and supplies	1,068	583
	\$ 1,693	\$ 826

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08. LONG TERM INVESTMENTS

At December 31, 2007 and December 31, 2006 the Company owned 3,706,250 shares of Continuum Resources Ltd. As at December 31, 2006 these were stated at cost. With the adoption of financial instruments standards, the Company measures these investments at fair value (Note 4). The fair value was determined based on published share prices of underlying securities on the active market. On adoption of financial instruments standards, a cumulative adjustment was recorded in other comprehensive income to reflect the change in accounting policy. During the year ended December 31, 2007 the decrease in fair value of \$352 (\$305 net of taxes) has been recognized in other comprehensive loss for the period (Note 16).

	December 31, 2007	December 31, 2006
Fair value	\$ 908	\$ -
Cost	741	741
Unrealized gain (cumulative)	\$ 167	\$ -

09. PROPERTY, PLANT & EQUIPMENT

Property, plant and equipment are comprised of the following:

	Cost	Accumulated Depreciation	Dec. 31, 2007 Net book value	Dec. 31, 2006 Net book value
Land	\$ 259	\$ -	\$ 259	\$ -
Machinery & equipment	8,222	1,034	7,188	4,526
Buildings	2,989	409	2,580	2,457
Furniture & other equipment	912	104	808	372
Transport units	524	75	449	174
Equipment under capital lease	1,035	71	964	169
Work in progress	1,421	-	1,421	108
	\$ 15,362	\$ 1,693	\$ 13,669	\$ 7,806

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10. MINERAL PROPERTIES

Mineral Properties are located in Peru and Mexico and are comprised of the following:

				Dec. 31, 2007	Dec. 31, 2006
	Cost	Depletion	Write-off	Net	Net
Peru - Caylloma	\$ 31,063	\$ 4,795	\$ -	\$ 26,268	\$ 23,965
Mexico – San Jose	26,070	-	-	26,070	18,564
Other	12	-	12	-	12
	\$ 57,145	\$ 4,795	\$ 12	\$ 52,338	\$ 42,541

The carrying amount of mineral properties at San Jose includes \$336 of capitalized interest on loans (Note 12). Additions to mineral properties are comprised of development and exploration costs capitalized and consist of \$6,526 at Caylloma and \$7,506 at San Jose properties for the year ended December 31, 2007. Included in additions to San Jose mineral properties are depreciation of equipment involved in construction work of \$57 (2006: \$nil), and general and administrative costs to develop the mine of \$929 (2006: \$nil).

San Jose Project, Mexico

The San Jose Project is owned and operated by Compañía Minera Cuzcatlan (“Cuzcatlan”), a company owned 76% by the Company and 24% by Continuum Resources Ltd (“Continuum”). The Company is the operator of the work programs and the Company and Continuum must contribute to the costs thereof in proportion to its ownership percentage in Cuzcatlan.

Cuzcatlan has been accounted for as a variable interest entity, as defined in CICA Accounting Guideline 15 “Consolidation of Variable Interest Entities” and has been consolidated from the date of acquisition. A non-controlling interest of \$6,593 has been recorded as at December 31, 2007 (December 31, 2006 - \$3,227).

11. RELATED PARTY TRANSACTIONS

The Company incurred charges from directors, officers, and companies having a common director or officer as follows:

	Year ended Dec. 31, 2007	15 Months ended Dec. 31, 2006
Mineral property costs – geological fees	\$ 45	\$ 174
Consulting fees	188	75
Salaries and wages	108	16
Management fees	266	146

These charges were measured at the exchange amount, which is the amount agreed upon by the transacting parties.

At December 31, 2007, due to related parties consists of \$14 (December 31, 2006 - \$27) owing to an officer and to companies with a common director. These amounts were incurred as a result of shared administrative costs. These amounts are unsecured, non-interest bearing and payable in the normal course of business.

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12. LOANS AND LEASES

On November 21, 2006 the Company borrowed \$4,600 at an interest rate of 12% from Quest Capital Corporation in connection with the acquisition of the San Jose property. The loan was due on May 30, 2007, however the \$4,600 plus interest of \$25 was paid back on January 15, 2007.

On October 30, 2006 a revolving credit line of US\$ 950 with a CDN value of \$1,079 as of December 31, 2006 and an interest rate of Libor + 1.5% plus a variable utilization fee, was taken for working capital purposes from Traxys North America. The amount of the credit line of \$1,079, plus interest and fees of \$41 was paid back on February 8, 2007.

At December 31, 2007 the Company has capital lease obligations of \$872 (December 31, 2006 - \$142) including a current portion of \$439 (December 31, 2006 - \$45). These are related to the acquisition of mining equipment, transport units and buildings. These obligations have terms of 24, 25 months and 36 months, have expiry dates ranging from October 5, 2009 to December 15, 2010 and bear interest at rates ranging from 8.16% to 8.92%. During the year ended December 31, 2007, \$132 was paid on the capital leases (15 month period ended December 31, 2006: \$29). During the year ended December 31, 2007 the Company assumed new capital lease obligations of \$862 (15 month period ended December 31, 2006: \$171)

13. ASSET RETIREMENT OBLIGATION

The Company has recorded an asset retirement obligation of \$1,916 as of December 31, 2007 as a result of accretion of the previously recorded asset retirement obligation of \$1,758 as of December 31, 2006 by \$158. The accretion expense was calculated over the year using a rate of 9%. The initial amount was based on an estimate prepared by an independent third party at the time of acquisition as to the cost of reclamation associated with the Caylloma property. The Company is currently reviewing its reclamation obligations at the property in light of changing regulations and on the basis of further data in respect of the mine life.

In view of the uncertainties concerning environmental reclamation, the ultimate cost of reclamation activities could differ materially from the estimated amount recorded. The estimate of the Company's asset retirement obligation relating to the Caylloma mine is subject to change based on amendments to laws and regulations and as new information regarding the Company's operations becomes available.

Future changes, if any, to the estimated liability as a result of amended requirements, laws, regulations, operating assumptions, estimated timing and amount of obligations may be significant and would be recognized prospectively as a change in accounting estimate. Any such change would result in an increase or decrease to the liability and a corresponding increase or decrease to the mineral property, plant and equipment balance.

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14. INCOME TAX

a) Income tax expense differs from the amount that would be computed by applying the Canadian statutory income tax rate of 34.12% (2006 – 34.12%) to loss before income taxes and non-controlling interest. The reasons for the differences are as follows:

	2007		2006	
Income (loss) before income taxes and non-controlling interest	\$	1,380	\$	(3,854)
Statutory income tax rate		34.12%		34.12%
Expected income tax (recovery)	\$	471	\$	(1,315)
Items (deductible) non-deductible for income tax purposes		(74)		1,430
Differences in tax rates in foreign jurisdictions and non-recognition benefits		3,202		(604)
Change in valuation allowance		662		983
Total income taxes	\$	4,261	\$	494
Represented by:				
Current income tax	\$	544	\$	-
Future income tax	\$	3,717	\$	494

b) The tax effects of temporary differences that give rise to significant portions of the future tax assets and future tax liabilities at December 31, 2007 and December 31, 2006 are presented below:

	2007		2006	
Future income tax assets (all arising in Canada):				
Non-capital losses	\$	1,275	\$	725
Financing costs		657		473
Undepreciated capital cost in excess of accounting net book value and other		4		-
Mineral properties		436		512
Valuation allowance		(2,372)		(1,710)
Future income tax liabilities:				
Long-term investments - Canada		(23)		-
Mineral properties – Peru		(5,910)		(2,624)
Mineral properties – Mexico		(2,136)		(2,286)
		(8,069)		(4,910)
Net future income tax (liabilities)	\$	(8,069)	\$	(4,910)

FORTUNA SILVER MINES INC.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Expressed in thousands of Canadian Dollars, except for share and per share amounts

15. SHARE CAPITAL

As at December 31, 2007, the Company had available the following amounts for deduction against future earnings in Canada:

Non-capital losses, expiring as follows:

2008 to 2010	\$	276
2014 to 2015		1,683
2026 to 2027		2,765
		4,724

Financing costs	\$	2,433
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a) Authorized: Unlimited common shares without par value

	Number of shares		Amount
Balance, September 30, 2005	20,083,465	\$	12,164
Exercise of options	650,000		424
Exercise of warrants	6,124,631		5,601
Private placement for cash	16,700,000		22,050
Private placement commission non-cash transaction (Note 18)	760,261		1,140
Property acquisition non-cash transaction (Note 18)	1,897,621		2,714
Property finders fee non-cash transaction (Note 18)	50,000		68
Property acquisition non-cash transaction (Note 18)	168,417		285
Loan fee (Note 18)	153,333		276
Transfer of contributed surplus on exercise of options	-		214
Less issue costs (non-cash amount \$1,140)	-		(1,595)
Balance, December 31, 2006	46,587,728	\$	43,341
Exercise of options	1,753,600		1,957
Exercise of warrants	14,214,035		21,057
Private placement for cash	18,000,000		34,200
Private placement commission non-cash transaction (Note 18)	422,300		802
Transfer of contributed surplus on exercise of options	-		1,289
Less issue costs (non-cash amount \$802)	-		(2,487)
Balance, December 31, 2007	80,977,663	\$	100,159

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b) Stock Options

A summary of stock options granted and exercised under the Company's stock option plan is as follows:

	Year ended Dec. 31, 2007		15 month period ended Dec 31, 2006	
	Number of Options	Weighted Average Exercised Price	Number of Options	Weighted Average Exercised Price
Outstanding, beginning of period	3,765,000	\$ 1.62	860,000	\$ 0.56
Granted	4,355,000	2.82	3,555,000	1.70
Exercised	(1,321,100)	1.48	(650,000)	0.65
Expired/cancelled	(112,500)	2.56	-	-
Outstanding, end of period	6,686,400	\$ 2.24	3,765,000	\$ 1.62

The following stock options were outstanding and exercisable at December 31, 2007:

Number of shares	Exercise Price \$	Expiry Date
39,000	0.37	December 2, 2009
30,000	0.80	July 24, 2010
285,000	1.35	February 5, 2016
451,000	2.29	March 30, 2016
60,000	1.75	May 8, 2016
200,000	1.75	May 22, 2016
280,000	1.55	July 5, 2016
860,000	1.66	July 10, 2016
225,000	1.61	September 13, 2016
20,000	1.90	November 20, 2016
50,000	1.96	November 23, 2016
1,391,400	2.22	January 11, 2017
80,000	2.75	February 6, 2017
15,000	3.09	April 22, 2017
50,000	3.10	May 31, 2017
50,000	3.10	June 17, 2017
50,000	3.05	June 27, 2017
2,025,000	3.22	July 2, 2017
250,000	2.97	September 23, 2017
250,000	2.82	October 9, 2010
25,000	3.10	October 24, 2017
6,686,400		

6,286,400 options have vested as at December 31, 2007. The average remaining life of the outstanding options at December 31, 2007 is 8.7 years.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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15. SHARE CAPITAL
(continued)**c) Warrants**

A summary of share purchase warrants issued and exercised is as follows:

	Year ended Dec. 31, 2007		15 month period ended Dec 31, 2006	
	Number of Warrants	Weighted Average Exercise Price	Number of Warrants	Weighted Average Exercise Price
Outstanding, beginning of period	20,566,185	\$ 1.23	13,114,117	\$ 0.91
Issued	10,559,725	2.30	13,576,699	1.40
Exercised	(14,646,535)	1.44	(6,124,631)	0.91
Outstanding, end of period	16,479,375	\$ 1.89	20,566,185	\$ 1.23

The following share purchase warrants were outstanding at December 31, 2007:

Number of warrants	Exercise Price \$	Expiry Date
4,322,596	1.850	March 23, 2008
862,117	0.345	June 27, 2010
1,613,238	0.345	November 17, 2010
960,969	2.300	July 11, 2008
8,720,455	2.300	July 11, 2008
16,479,375		

d) Stock-Based Compensation

The Company uses the fair value based method of accounting for share options granted to consultants, directors, officers and employees. The non-cash compensation charge of \$6,974 recognized for the year ended December 31, 2007 (15 month period ended December 31, 2006: \$4,132) is associated with the granting of options to a consultant, directors and employees. These compensation charges have been determined under the fair value method using the Black-Scholes option pricing model with the following assumptions:

	Year Ended Dec. 31, 2007	15 month period Ended Dec. 31, 2006
Risk-free interest rate	4.04% - 4.67%	2.93% - 4.59%
Expected stock price volatility	59% - 68%	43% - 92%
Expected term in years	5 & 10	5 & 10
Expected dividend yield	0%	0%

Option pricing models require the input of highly subjective assumptions including the estimate of the share price volatility, risk-free interest rate and expected life of the options. Changes in the subjective input assumptions can materially affect the fair value estimate, and therefore the existing models do not necessarily provide a reliable single measure of the fair value of the Company's stock options.

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16. ACCUMULATED OTHER COMPREHENSIVE INCOME	December 31, 2007
Balance at December 31, 2006	\$ -
Cumulative impact of accounting changes, net of tax (Note 4)	449
Adjusted balance January 1, 2007	449
Unrealized (loss) on available-for-sale long term investment, net of tax (Note 8)	(305)
Balance at December 31, 2007	\$ 144

**17. SEGMENTED
INFORMATION**

The Company is currently engaged in mining and the development of mineral properties. Details on a geographical basis are as follows:

	Canada	Peru	Mexico	Other	Total
Year ended December 31, 2007					
Revenue	\$ -	\$ 31,667	\$ -	\$ -	\$ 31,667
Operating (loss) income	\$ (8,836)	\$ 8,972	\$ -	\$ (29)	\$ 107
As at December 31, 2007					
Property, plant & equipment	\$ 7	\$ 9,252	\$ 4,407	\$ 3	\$ 13,669
Total assets	\$ 40,273	\$ 49,297	\$ 34,155	\$ 721	\$ 124,446
15 month period ended December 31, 2006					
Revenue	\$ -	\$ 3,372	\$ -	\$ -	\$ 3,372
Operating (loss)	\$ (5,731)	\$ 771	\$ -	\$ (40)	\$ (5,000)
As at December 31, 2006					
Property, plant & equipment	\$ 9	\$ 7,792	\$ 2	\$ 3	\$ 7,806
Total assets	\$ 2,589	\$ 36,762	\$ 19,829	\$ 14	\$ 59,194

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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**18. SUPPLEMENTARY
DISCLOSURE OF
NON-CASH
TRANSACTIONS**

Investing and financing activities that do not have a direct impact on current cash flows are excluded from the statements of cash flows.

The following non-cash transactions occurred:

	15 month period ended Dec. 31, 2006	
	Number of shares	Amount
Shares issued for property acquisition, previously booked as an obligation	1,897,621	\$ 2,714
Warrants issued for property acquisition, previously booked as an obligation	1,613,238	\$ 1,871
Shares issued for property finders fees	50,000	\$ 68
Shares issued for commission on private placement	760,261	\$ 1,140
Shares issued for property acquisition	168,417	\$ 284,625
Shares issued to continuum for property acquisition	1,293,750	\$ 284,625
Shares issued for consideration on Quest loan	153,333	\$ 275,999
Fair market value of options exercised	-	\$ 214

	Year ended Dec. 31, 2007	
	Number of shares	Amount
Shares issued for commission on private placement	422,300	\$ 802
Purchase of equipment on a deferred payment plan	-	\$ 847
Fair value of options exercised	-	\$ 1,289

19. COMMITMENTS

The Company has a thirteen month contract with one customer who purchases the full production from the Company's operating Caylloma mine. Under the contract, the Company is committed to supply 4,800 tons of lead concentrate and 7,200 tons of zinc. As at December 31, 2007, the Company fulfilled this commitment.

A processing plant was purchased in Mexico in the first quarter of 2007 for US\$2,250,000 to be paid in three installments of US\$750,000. The first installment was paid on February 1, 2007 and the second installment was paid on August 1, 2007. The final installment was paid on February 1, 2008 and is included in accounts payable and accrued liabilities at December 31, 2007.

The Company has a contract to guarantee power supply at its Caylloma mine. Under the contract the seller is obligated to deliver a "maximum committed demand" (for the present term this stands at 2,800 Kw) and Bateas is obligated to purchase subject to exemptions under provisions of "Force Majeure". The contract is automatically renewed every two years for a period of 10 years. Renewal can be avoided without penalties by notifying 10 months in advance of renewal date. Tariffs are established yearly by energy market regulator in accordance with applicable regulations in Peru.

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20. SUBSEQUENT EVENTS

Subsequent to December 31, 2007, the Company received \$34 from the exercise of 21,400 options and \$7,997 from the exercise of 4,322,596 warrants.

On February 6, 2008 options were granted to purchase up to 250,000 common shares exercisable for 10 years at a price of \$2.52 per share.

During January 2008 the Company entered into additional derivative contracts spread out evenly over the period from February 2008 to January 2009 (Note 5).

The following Zinc Forward sale contract was entered into on a SWAP basis:

- USD 2,360/t, for the total of 1,700 tons

The contract is settled against the arithmetic average of zinc spot prices over the month in which the contract matures.

The following Lead Asian Option contracts were entered into:

- Long put options at strike price: USD 2,575/t, for the total of 1,025 tons
- Short call options at strike price: USD 2,760/t, for the total of 1,025 tons
- Long call options at strike price: USD 3,300/t, for the total of 1,025 tons

21. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the current year's presentation.

Corporate Information

Qualified Person

Gregory Smith, PGeo, is the company's qualified person, as defined by National Instrument 43-101, and is responsible for verifying the accuracy of the technical information in this Annual Report.

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Share Transfer Agent:

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Lima Exchange: FVI
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