



**FORTUNA**  
SILVER MINES INC.

**FINANCIAL REVIEW**

**Second Quarter Ended June 30, 2011**



Fortuna Silver Mines Inc.

June 30, 2011

Condensed Interim Consolidated Financial Statements

**August 10, 2011**

**(Unaudited - All amounts in US\$'000's unless otherwise stated)**

**FORTUNA SILVER MINES INC.**  
**CONDENSED INTERIM CONSOLIDATED STATEMENTS OF INCOME**  
(Unaudited - Expressed in thousands of US Dollars, except for share and per share amounts)

	Notes	Three months ended June 30,		Six months ended June 30,	
		2011	2010	2011	2010
Sales		\$ 24,267	\$ 14,421	\$ 45,940	\$ 31,797
Cost of sales		9,422	7,507	18,042	15,427
<b>Mine operating income</b>		<b>14,845</b>	6,914	<b>27,898</b>	16,370
<b>Other expenses</b>					
Selling, general and administrative expenses	9a) b) d)	5,331	-	8,963	1,993
Exploration and evaluation costs		318	173	673	242
Net (gain) on commodity contracts		(1,438)	(2,895)	(427)	(4,642)
(Gain) loss on disposal of mineral properties, property, plant and equipment		(31)	7	(53)	110
<b>Operating income</b>		<b>10,665</b>	9,629	<b>18,742</b>	18,667
<b>Finance items</b>					
Interest income		228	109	478	181
Interest expense		(139)	(72)	(276)	(148)
<b>Net finance income</b>		<b>89</b>	37	<b>202</b>	33
<b>Income before tax</b>		<b>10,754</b>	9,666	<b>18,944</b>	18,700
Income taxes		4,557	2,947	7,965	6,257
<b>Income for the period</b>		<b>\$ 6,197</b>	\$ 6,719	<b>\$ 10,979</b>	\$ 12,443
<b>Earnings per Share - Basic</b>		<b>\$ 0.05</b>	\$ 0.06	<b>\$ 0.09</b>	\$ 0.12
<b>Earnings per Share - Diluted</b>		<b>\$ 0.05</b>	\$ 0.06	<b>\$ 0.09</b>	\$ 0.11
<b>Weighted average number of shares outstanding - Basic</b>		<b>123,024,331</b>	110,164,718	<b>122,817,978</b>	105,040,478
<b>Weighted average number of shares outstanding - Diluted</b>		<b>124,805,640</b>	113,490,707	<b>124,686,180</b>	108,241,221

**FORTUNA SILVER MINES INC.**  
**CONDENSED INTERIM CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(Unaudited - Expressed in thousands of US Dollars)

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
<b>Income for the period</b>	\$ 6,197	\$ 6,719	\$ 10,979	\$ 12,443
<b>Other comprehensive (loss) income</b>				
Unrealized (loss) gain on translation to reporting currency	(111)	(1,298)	1,802	(59)
<b>Other comprehensive (loss) income</b>	<b>(111)</b>	<b>(1,298)</b>	<b>1,802</b>	<b>(59)</b>
<b>Total comprehensive income for the period</b>	<b>\$ 6,086</b>	<b>\$ 5,421</b>	<b>\$ 12,781</b>	<b>\$ 12,384</b>

**FORTUNA SILVER MINES INC.**  
**CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited - Expressed in thousands of US Dollars)

	Notes	Six months ended June 30,	
		2011	2010
<b>OPERATING ACTIVITIES</b>			
Net income before income taxes and interest	\$	18,742	\$ 18,667
Items not involving cash			
Depletion and depreciation		3,327	2,990
Discount unwinding		81	80
Deferred income taxes		308	2,652
Share-based payments		2,004	(2,440)
Unrealized gain on commodity contracts		(1,186)	(6,318)
(Gain) loss on disposal of mineral properties, property, plant and equipment		(53)	107
Accrued interest on loans receivable and payable		12	29
		<b>23,235</b>	15,767
Changes in non-cash working capital items			
Accounts receivable and prepaid expenses		3,211	(351)
Inventories		(2,259)	(855)
Trade and other payables		2,947	1,564
Due to related parties		1,307	(35)
Income tax payable		(828)	(910)
<b>Cash provided by operating activities</b>		<b>27,613</b>	15,180
Income taxes		(7,965)	(6,257)
Interest income		202	33
<b>Net cash provided by operating activities</b>		<b>19,850</b>	8,956
<b>INVESTING ACTIVITIES</b>			
Purchase of short term investments		(30,818)	(17,980)
Redemptions in short term investments		41,049	7,832
Expenditures on mineral properties, property, plant and equipment		(34,115)	(11,206)
Payments of value added taxes on purchase of property, plant and equipment		(403)	(569)
Advances of deposits on long term assets		(25,541)	-
Receipts of deposits on long term assets		22,174	-
Proceeds on disposal of mineral properties, property, plant and equipment		-	13
<b>Net cash used in investing activities</b>		<b>(27,654)</b>	(21,910)
<b>FINANCING ACTIVITIES</b>			
Proceeds from long term debt		18	-
Repayment of long term debt		(18)	-
Net proceeds on issuance of common shares		455	31,549
Repayment of finance lease obligations		(556)	(552)
<b>Net cash (used in) provided by financing activities</b>		<b>(101)</b>	30,997
Effect of exchange rate changes on cash and cash equivalents		1,385	79
<b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>		<b>(7,905)</b>	18,043
Cash and cash equivalents - beginning of year		70,298	30,763
<b>CASH AND CASH EQUIVALENTS - END OF PERIOD</b>	\$	<b>63,778</b>	\$ 48,885

Supplemental cash flow information

13

The accompanying notes are an integral part of these unaudited condensed interim consolidated financial statements  
Page 4

**FORTUNA SILVER MINES INC.**  
**CONDENSED INTERIM CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**  
(Unaudited - Expressed in thousands of US Dollars)

	Notes	June 30, 2011	December 31, 2010
<b>ASSETS</b>			
<b>CURRENT ASSETS</b>			
Cash and cash equivalents	3	\$ 63,778	\$ 70,298
Short term investments		10,763	20,509
Derivatives	4	1,054	-
Accounts receivable and other assets	5	10,712	13,454
GST/HST and value added tax receivable	5	3,965	3,542
Inventories	6	6,277	4,018
		<b>96,549</b>	111,821
<b>NON-CURRENT ASSETS</b>			
Deposits on long term assets	5	9,171	4,686
Mineral properties, property, plant and equipment	7, 9b, 9d)	147,308	117,363
<b>Total assets</b>		<b>\$ 253,028</b>	<b>\$ 233,870</b>
<b>LIABILITIES AND EQUITY</b>			
<b>CURRENT LIABILITIES</b>			
Trade and other payables	8	\$ 13,367	\$ 9,303
Due to related parties	9 c)	1,349	40
Derivatives	4	-	133
Income tax payable		3,364	4,192
Current portion of long term liability	10	1,911	1,083
		<b>19,991</b>	14,751
<b>NON-CURRENT LIABILITIES</b>			
Leases and long term liabilities	10	2,988	3,166
Provisions	11	5,114	4,881
Deferred income tax liabilities		8,790	8,482
		<b>36,883</b>	31,280
<b>EQUITY</b>			
Share capital		181,289	180,403
Share option and warrant reserve		11,003	11,116
Retained earnings		19,328	8,348
Accumulated other comprehensive income		4,525	2,723
		<b>23,853</b>	11,071
		<b>216,145</b>	202,590
		<b>\$ 253,028</b>	<b>\$ 233,870</b>
<b>Contingencies and capital commitments</b>	<b>17</b>		
<b>Subsequent event</b>	<b>18</b>		
<b>First-time adoption of IFRS</b>	<b>19</b>		

APPROVED BY THE DIRECTORS:

"Jorge Ganoza Durant", Director  
Jorge Ganoza Durant

"Robert R. Gilmore", Director  
Robert R. Gilmore

**FORTUNA SILVER MINES INC.**  
**CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**  
(Unaudited - Expressed in thousands of US Dollars, except for share amounts)

	Attributable to equity holders of the Company							
	Share Capital		Share option and warrant reserve	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss) ("AOCI")	Total Retained Earnings (Deficit) and AOCI	Total Shareholders' Equity	
	Shares	Amount						
Balance - December 31, 2010	122,497,465	\$ 180,403	\$ 11,116	\$ 8,348	\$ 2,723	\$ 11,071	\$ 202,590	
Issuance of shares under bought deal financing, net of issuance costs	-	(95)	-	-	-	-	(95)	
Exercise of options	587,000	550	-	-	-	-	550	
Issuance of shares for property	6,756	30	-	-	-	-	30	
Transfer of contributed surplus on exercise of options	-	401	(401)	-	-	-	-	
Share-based payments on option grants	-	-	288	-	-	-	288	
Income for the period	-	-	-	10,979	-	10,979	10,979	
Unrealized gain on translation to reporting currency	-	-	-	-	1,802	1,802	1,802	
Total comprehensive income for the period				10,979	1,802	12,781	12,781	
<b>Balance - June 30, 2011</b>	<b>123,091,221</b>	<b>\$ 181,289</b>	<b>\$ 11,003</b>	<b>\$ 19,328</b>	<b>\$ 4,525</b>	<b>\$ 23,853</b>	<b>\$ 216,145</b>	
Balance - December 31, 2009	94,982,652	\$ 104,701	\$ 14,315	\$ (7,655)	\$ -	\$ (7,655)	\$ 111,361	
Issuance of shares under bought deal financing, net of issuance costs	15,007,500	31,214	-	-	-	-	31,214	
Exercise of options	384,500	336	-	-	-	-	336	
Issuance of shares for property	7,813	20	-	-	-	-	20	
Transfer of contributed surplus on exercise of options	-	256	(256)	-	-	-	-	
Share-based payments (recoveries) on option grants	-	-	(2,440)	-	-	-	(2,440)	
Income for the period	-	-	-	12,443	-	12,443	12,443	
Unrealized (loss) on translation of functional currency to reporting currency	-	-	-	-	(59)	(59)	(59)	
Total comprehensive income for the period				12,443	(59)	12,384	12,384	
Balance - June 30, 2010	110,382,465	\$ 136,527	\$ 11,619	\$ 4,788	\$ (59)	\$ 4,729	\$ 152,875	

## **FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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### **1. Corporate Information**

Fortuna Silver Mines Inc. ("Fortuna" or the "Company") is engaged in silver mining and related activities, in Latin America, 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.

Fortuna is a publicly traded company incorporated and domiciled in Canada with its primary listing on the Toronto Stock Exchange.

The Company's registered office is at Suite 840, 355 Burrard Street, Vancouver, British Columbia, Canada, V6C 2G8.

### **2. Basis of Consolidation and Summary of Significant Accounting Policies**

#### **a) Statement of Compliance**

These condensed interim consolidated financial statements are prepared in accordance with International Accounting Standards ("IAS") 34, *Interim Financial Reporting*, as issued by the International Accounting Standards Board ("IASB"). The policies applied in these condensed interim consolidated financial statements are based on International Financial Reporting Standards ("IFRS") issued and outstanding as at August 10, 2011, the date the Board of Directors approved these interim financial statements for issue. Any subsequent changes to IFRS that are issued and effective as at December 31, 2011 could result in a restatement of these interim financial statements, including the transition adjustments recognized on conversion to IFRS. The condensed interim consolidated financial statements do not include all of the information required for full annual financial statements.

The unaudited condensed interim consolidated financial statements of Fortuna Silver Mines Inc. (the "Company") for the three and six month periods ended June 30, 2011 ("Financial Statements") have been prepared by management. The Financial Statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2010, and the unaudited condensed interim consolidated financial statements for the first quarter ended March 31, 2011, which are available at the SEDAR website at [www.sedar.com](http://www.sedar.com). The Financial Statements are stated in terms of thousands of United States dollars, unless otherwise indicated, and are prepared in accordance with International Financial Reporting Standards.

#### **b) Basis of Consolidation**

These Financial Statements include the accounts of the Company and wholly owned subsidiaries: Minera Bateas S.A.C. ("Bateas"); Fortuna Silver (Barbados) Inc.; Compania Minera Cuzcatlan SA ("Cuzcatlan"); Continuum Resources Ltd. ("Continuum"); Fortuna Silver Mines Peru S.A.C. ("FSM Peru"); and Fortuna Silver Mexico, S.A. de CV. ("FS Mexico").

All significant inter-company transactions and accounts have been eliminated upon consolidation.



**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)****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. Final commodity prices are set in a period subsequent to the date of sale based 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 forward market price. Variations recorded between the price recorded at the time of provisional settlement and the actual final price are caused by changes in metal prices.

**d) Cash and Cash Equivalents**

Cash and cash equivalents are designated as fair value through profit and loss ("FVTPL"). Transaction costs are expensed when incurred through profit and loss. Cash and cash equivalents include cash on hand, demand deposits, and money market instruments, with maturities from the date of acquisition of 90 days or less, which are readily convertible to known amounts of cash and are subject to insignificant changes in value.

**e) Mineral Properties, Property, Plant and Equipment**

Costs directly related to construction projects are capitalized to work-in-progress until the asset is available for use in the manner intended by management. Completed property, plant and equipment is recorded at cost, net of accumulated depreciation and accumulated impairments. Assets will be depreciated to their residual values over their estimated useful lives as follows:

*Land and buildings*

Land	Not depreciated	
Mineral property	Units of production	
Buildings	6 - 20 years	Straight line
Leasehold Improvements	7 - 8 years	Straight line

*Plant and equipment*

Machinery and equipment	3 - 8 years	Straight line
Furniture and other equipment	3 - 13 years	Straight line
Transport units	4 - 5 years	Straight line

*Capital work in progress* Not depreciated

Equipment under finance lease is initially recorded at the present value of minimum lease payments at the inception of the lease. Spare parts and components included in machinery and equipment, depending on the replacement period of the initial component, are depreciated over 8 to 18 months.

Borrowing costs allocable to the costs of construction projects are capitalized on a net basis and included in the carrying amounts of related assets until the asset is ready for use in the manner intended by management.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**e) Mineral Properties, Property, Plant and Equipment (continued)**

Costs associated with commissioning activities on constructed plants are deferred from the date of mechanical completion of the facilities until the date the assets are ready for use in the manner intended by management.

On an annual basis, the depreciation method, useful economic life and the residual value of each component asset is reviewed, with any changes recognized prospectively over its remaining useful economic life.

*i. Evaluation and Exploration Assets*

Significant payments related to the acquisition of land and mineral rights are capitalized as incurred. Prior to acquiring such land or mineral rights, the Company makes a preliminary evaluation to determine that the property has significant potential to develop an economic ore body. The time between initial acquisition and full evaluation of a property's potential is dependent on many factors including: location relative to existing infrastructure, the property's stage of development, geological controls and metal prices.

The Company defers the cost of acquiring, maintaining its interest, exploring and developing mineral properties as exploration and evaluation assets when future inflow of economic benefits from the properties is probable and until such time as the properties are placed into development, abandoned, sold or considered to be impaired in value.

If a mineable ore body is discovered, exploration and evaluation costs are reclassified to mining properties. If no mineable ore body is discovered, such costs are expensed in the period in which it is determined the property has no future economic value.

Proceeds received from the sale of interests in exploration and evaluation assets are credited to the carrying value of the mineral properties, with any excess included in income.

Write-downs due to impairment in value are charged to income. The cash-generating unit for assessing impairment is a geographic region and shall be no larger than the operating segment.

Exploration costs that do not relate to any specific property are expensed as incurred.

*ii. Operational Mining Properties and Mine Development*

For operating mines, all 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.

Costs of producing properties are amortized on a unit-of-production basis over proven and probable reserves, and costs of abandoned properties are written-off.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**f) Asset Impairment**

Assets are assessed for impairment at each reporting date when changes in events or circumstances occur that indicate the assets may not be recoverable. An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less cost to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest level for which there are separately identifiable cash flows or cash generating units. These are typically individual mines or development projects. Brownfields exploration projects, located close to existing mine infrastructure, are assessed for impairment as part of the associated mine cash generating unit.

When the recoverable amount is assessed using pre-tax discounted cash flow techniques, the resulting estimates are based on detailed mine and/or production plans. For value in use, recent cost levels are considered, together with expected changes in costs that are compatible with the current condition of the business.

The cash flow forecasts are based on best estimates of expected future revenues and costs, including the future cash costs of production, capital expenditure and reclamation and closures costs.

Where a fair value less cost to sell model is used the cash flow forecast may include net cash flows expected to be realized from extraction, processing and sale of mineral resources that do not currently qualify for inclusion in proven or probable reserves.

Where an impairment loss subsequently reverses, the carrying amount of the asset or cash-generating unit is increased to the revised estimate of recoverable amount, but not beyond the carrying amount that would have been determined had no impairment loss been recognized for the asset or cash-generating unit in prior years. A reversal of an impairment loss is recognized into earnings immediately.

**g) Provisions**

***i. Decommissioning and restoration provisions***

Future obligations to retire an asset, including dismantling, remediation and ongoing treatment and monitoring of the site related to normal operations are initially recognized and recorded as a liability based on estimated future cash flows discounted at a credit adjusted risk-free rate. The decommissioning and restoration provision ("DRP") is adjusted at each reporting period for changes to factors including the expected amount of cash flows required to discharge the liability, the timing of such cash flows and the credit adjusted risk-free discount rate.

The liability is accreted to full value over time through periodic charges to income. This unwinding of the discount is charged to finance costs in the condensed interim consolidated statements of income.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**g) Provisions (continued)**

*i. Decommissioning and restoration provisions (continued)*

The amount of the DRP initially recognized is capitalized as part of the related asset's carrying value and amortized to income. The method of amortization follows that of the underlying asset. The costs related to a DRP are only capitalized to the extent that the amount meets the definition of an asset and can bring about future economic benefit. For a closed site or where the asset which generated a DRP no longer exists, there is no longer future benefit related to the costs and as such, the amounts are expensed. For operating sites, a revision in estimates or a new disturbance will result in an adjustment to the liability with an offsetting adjustment to the capitalized retirement cost. For closed sites, adjustments to the DRP that are required as a result of changes in estimates are charged to income in the period in which the adjustment is identified.

*ii. Environmental disturbance restoration provisions*

During the operating life of an asset, events such as infractions of environmental laws or regulations may occur. These events are not related to the normal operation of the asset and are referred to as environmental disturbance restoration provisions ("EDRP"). The costs associated with an EDRP are accrued and charged to earnings in the period in which the event giving rise to the liability occurs. Any subsequent adjustments to an EDRP due to changes in estimates are also charged to earnings in the period of adjustment. These costs are not capitalized as part of the long-lived asset's carrying value.

*iii. Other provisions*

Provisions are recognized when a present legal or constructive obligation exists, as a result of past events, and it is probable that an outflow of resources that can be reliably estimated will be required to settle the obligation. Where the effect is material, the provision is discounted using an appropriate current market-based pre-tax discount rate.

**h) Inventories**

Inventories include metals contained in concentrates, stockpiled ore, materials, and supplies. The classification of metals inventory is determined by the stage in the production process. Product inventories are sampled for metal content and are valued based on the lower of actual production costs incurred or estimated net realizable value based upon the period ending prices of contained metal.

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

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**i) Income taxes**

Income tax expense consists of current and deferred tax expense. Income tax is recognized in the income or loss.

Current tax expense is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at period end, adjusted for amendments to tax payable with regards to previous years.

Deferred tax assets and liabilities are recognized for deferred tax consequences attributable to unused tax loss carry forwards, unused tax credits and differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted or substantially enacted tax rates expected to apply when the asset is realized or the liability settled.

The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income or loss in the period that substantive enactment occurs.

A deferred tax asset is recognized to the extent that it is probable that future taxable income will be available against which the asset can be utilized. To the extent that the Company does not consider it probable that deferred tax asset will be recovered, the deferred tax asset is reduced.

The following temporary differences do not result in deferred tax assets or liabilities:

- the initial recognition of assets or liabilities, not arising in a business combination, that does not affect accounting or taxable income
- goodwill
- investments in subsidiaries, associates and jointly controlled entities where the timing of reversal of the temporary differences can be controlled and reversal in the foreseeable future is not probable.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to the set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Company intends to settle its current tax assets and liabilities on a net basis.

**j) Share-Based Payments**

The fair value method of accounting is used for share-based payment transactions. Under this method, the cost of share options and other equity-settled share-based payment arrangements are recorded based on the estimated fair value at the grant date and charged to earnings over the vesting period. Where awards are forfeited because non-market based vesting conditions are not satisfied, the expense previously recognized is proportionately reversed in the period the forfeiture occurs.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**j) Share-Based Payments (continued)**

Share-based payment expense relating to cash-settled awards, including deferred and restricted share units is accrued over the vesting period of the units based on the quoted market value of Company's common shares. As these awards will be settled in cash, the expense and liability are adjusted each reporting period for changes in the underlying share price.

*i. Stock Option Plan*

The Company applies the fair value method of accounting for all stock option awards. Under this method, the Company recognizes a compensation expense for all stock options awarded to employees, based on the fair value of the options on the date of grant which is determined by using the Black-Scholes option pricing model. The fair value of the options is expensed over the vesting period of the options.

*ii. Deferred Share Unit ("DSU") Plan*

The Company's DSU compensation liability is accounted for based on the number of units outstanding and the quoted market value of the Company's common shares at the financial position date. The year-over-year change in the deferred share unit compensation liability is recognized in income.

*iii. Restricted Share Unit ("RSU") Plan*

The Company recognizes a compensation cost in operating income on a prescribed vesting basis for each RSU granted equal to the quoted market value of the Company's common shares at the date of which RSUs are awarded to each participant prorated over the performance period and adjusts for changes in the fair value until the end of the performance date. The cumulative effect of the change in fair value is recognized in income in the period of change.

**k) Earnings (Loss) per Share**

Basic earnings (loss) per share is computed by dividing net income (loss) attributable to shareholders of the Company by the weighted average number of common shares outstanding during the period.

The diluted earnings (loss) per share calculation is based on the weighted average number of common shares outstanding during the period, plus the effects of dilutive common share equivalents. This method requires that the dilutive effect of outstanding options issued should be calculated using the treasury stock method. This method assumes that all common share equivalents have been exercised at the beginning of the period (or at the time of issuance, if later), and that the funds obtained thereby were used to purchase common shares of the Company at the average trading price of the common shares during the period, but only if dilutive.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**l) Foreign Currency Translation**

The presentation currency of the Company is the United States Dollar ("US\$").

The functional currency of each of the entities in the group is the US\$, with the exception of the parent entity and certain holding companies which have a Canadian dollar functional currency.

Transactions in foreign currencies are initially recorded in the functional currency at the exchange rate at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange at each financial position date. Foreign exchange gains or losses on translation to the functional currency of an entity are recorded in income. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate as at the date of the initial transaction.

For entities with a functional currency different from the presentation currency, translation to the presentation currency is required. Assets and liabilities are translated at the rate of exchange at the financial position date. Revenue and expenses are translated at the average rate for the period. All resulting exchange differences are recognized in other comprehensive income.

**m) Financial Instruments**

*i. Financial Assets*

The Company classifies all financial assets as either fair value through profit and loss ("FVTPL"), held-to-maturity ("HTM"), loans and receivables, or available-for-sale "(AFS)". The classification is determined at initial recognition and depends on the nature and purpose of the financial asset.

**a) Financial Assets at Fair Value Through Profit or Loss**

Financial assets are classified as FVTPL when the financial asset is held-for-trading or it is a designated FVTPL. A financial asset is classified in this category if acquired principally for the purpose of selling in the short-term.

Financial assets classified as FVTPL are stated at fair value with any resultant gain or loss recognized in income or loss in the period in which they arise. Transaction costs related to financial assets classified as FVTPL are recognized immediately in net income (loss).

Derivatives are categorized as held-for-trading. Derivatives are initially recognized at fair value on the date a derivative contract is entered into and are subsequently remeasured at their fair value. Fair value of the Company's recognized commodity-based derivatives are based on the forward prices of the associated market index. Gains or losses are recorded in the statement of income.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**m) Financial Instruments (continued)**

*i. Financial Assets (continued)*

**b) Held-to-Maturity Investments**

HTM investments are recognized on a trade-date basis and are initially measured at fair value, including transaction costs. The Company does not have any assets classified as HTM investments.

**c) Loans and Receivables**

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are stated at fair value, net of transaction costs and are classified as current or non-current assets based on their maturity date. They are carried at amortized cost less any impairment. The impairment loss of receivables is based on a review of all outstanding amounts at period end. Interest income is recognized by applying the effective interest rate, except for short term receivables when the recognition of interest would not be material.

**d) Available-For-Sale**

AFS financial assets are non-derivatives that are either designated in this category or not classified in any of the other categories.

Available-for-sale financial instruments are measured at fair value, determined by published market prices in an active market, except for investments in equity instruments that do not have quoted market prices in an active market which are measured at cost. Changes in fair value are recorded in other comprehensive income (loss) until the assets are removed from the statement of financial position. Investments classified as available-for-sale are written down to fair value through income whenever it is necessary to reflect other than-temporary impairment. Realized gains and losses on the disposal of available-for-sale securities are recognized in investment and other income.

The Company does not have any assets classified as AFS.



**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**m) Financial Instruments (continued)**

*i. Financial Assets (continued)*

**e) Impairment of Financial Assets**

Financial assets, other than those at FVTPL, are assessed for indicators of impairment at each period end. Financial assets are impaired when there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been impacted.

Objective evidence of impairment could include the following:

- significant financial difficulty of the issuer or counterparty;
- default or delinquency in interest or principal payments; or
- it has become probable that the borrower will enter bankruptcy or financial reorganization.

For financial assets carried at amortized cost, the amount of the impairment is the difference between the asset's carrying amount and the present value of the estimated future cash flows, discounted at the financial asset's original effective interest rate.

The carrying amount of all financial assets, excluding trade receivables, is directly reduced by the impairment loss. The carrying amount of trade receivables is reduced through the use of an allowance account. When a trade receivable is considered uncollectable, it is written off against the allowance account. Subsequent recoveries of amounts previously written off are credited against the allowance account. Changes in the carrying amount of the allowance account are recognized in income or loss.

With the exception of AFS equity instruments, if a subsequent period, the amount of the impairment loss decreases and the decrease relates to an event occurring after the impairment was recognized, the previously recognized impairment loss is reverse through income or loss. On the date of impairment reversal, the carrying amount of the financial asset cannot exceed its amortized cost had impairment not been recognized.

**f) Derecognition of Financial Assets**

A financial asset is derecognized when:

- the contractual right of the asset's cash flows expire; or
- if the Company transfers the financial asset and substantially all risks and reward of ownership to another entity.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)****m) Financial Instruments (continued)****ii. Financial Liabilities**

Long term debt and other financial liabilities are recognized initially at the fair value, net of transaction costs incurred, and are subsequently stated at amortized cost. Any difference between the amounts originally received (net of transaction costs) and the redemption value is recognized in the income statement over the period to maturity using the effective interest method.

**iii. Classification and Subsequent Measurements**

The Company has designated each of its significant categories of financial instruments as follows:

<u>Financial Instrument</u>	<u>Classification</u>	<u>Measurement</u>
Cash and Cash Equivalents	FVTPL	Fair value
Short Term Investments	FVTPL	Fair value
Accounts Receivable	Loans and receivables	Amortized cost
Long Term Receivables	Loans and receivables	Amortized cost
Derivatives	FVTPL	Fair value
Trade and other payables	Other liabilities	Amortized cost
Income Tax Payable	Other liabilities	Amortized cost
Due to Related Parties	Other liabilities	Amortized cost
Long Term Liability	Other liabilities	Amortized cost

The carrying value of cash and cash equivalents, receivables, and trade and other payables approximate their fair value because of the short-term maturity of those instruments.

**iv. Effective Interest Method**

The effective interest method calculates the amortized cost of a financial instrument and allocates interest income or expense over the corresponding period. The effective interest rate is the rate that discounts estimated future cash receipts or payments over the expected life of the financial instrument, or where appropriate, a shorter period, to the net carrying amount on initial recognition. Income or expense is recognized on an effective interest basis for instruments other than those financial instruments classified as FVTPL.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**n) Segment Reporting**

A geographical segment is a distinguishable component of the entity that is engaged in providing products or services within a particular economic environment and is subject to risks and returns that are different than those of segments operating in other economic environments.

The business operations comprise the mining and processing of silver-lead and zinc and the sale of these products.

**o) Leases**

A lease is a finance lease when substantially all of the risks and rewards incidental to ownership of the leased asset are transferred from the lessor to the lessee by the agreement. The leased assets are initially recorded at the lower of the fair value and the present value of the minimum lease payments and are depreciated over the shorter of the assets' useful lives and the term of the lease. Interest on the lease installments is recognized as interest expense over the lease term using the effective interest method. Leases for land and buildings are recorded separately if the lease payments can be allocated accordingly.

Leases that do not transfer all the risks and rewards of ownership are classified as operating leases. Payments are recorded in the income statement using the straight line method over their estimated useful lives.

**p) Share Capital**

Common shares are classified as equity. Incremental costs directly attributable to the issue of shares are shown in equity as a deduction from the proceeds.

**q) Related Party Transactions**

Parties are considered to be related if one party has the ability directly, or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control, related parties may be individuals or corporate entities. A transaction is considered to be a related party transaction when there is a transfer of resources or obligations between related parties.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)****r) Significant Accounting Judgments and Estimates**

The preparation of these condensed interim consolidated financial statements requires management to make judgments and estimates that affect the reported amounts of assets and liabilities at the date of the financial statements and reported amounts of expenses during the reporting period. Actual outcomes could differ from these judgments and estimates. The condensed interim consolidated financial statements include judgments and estimates which, by their nature, are uncertain. The impacts of such judgments and estimates are pervasive throughout the condensed interim consolidated financial statements, and may require accounting adjustments based on future occurrences. Revisions to accounting estimates are recognized in the period in which the estimate is revised and the revision affects both current and future periods.

Significant assumptions about the future and other sources of judgments and estimates that management has made at the statement of financial position date, that could result in a material adjustment to the carrying amounts of assets and liabilities, in the event that actual results differ from assumptions made, relate to, but are not limited to, the following:

**i. Critical Judgments**

- The analysis of the functional currency for each entity of the Company. In concluding that the United States dollar ("US\$"), with the exception of the parent entity and certain holding companies which have a Canadian dollar ("CAD\$") functional currency, management considered the currency that mainly influences the cost of providing goods and services in each jurisdiction in which the Company operates. As no single currency was clearly dominant the Company also considered secondary indicators including the currency in which funds from financing activities are denominated and the currency in which funds are retained.

**ii. Estimates**

- the recoverability of amounts receivable which are included in the consolidated statements of financial position;
- the estimation of assay grades of metal concentrates sold in the determination of the carrying value of accounts receivable which are included in the consolidated statements of financial position and included as sales in the consolidated statements of income;
- the carrying value of the short term investments and the recoverability of the carrying value which are included in the consolidated statements of financial position;
- the determination of net realizable value of inventories on the consolidated statements of financial position;
- the estimated useful lives of property, plant and equipment which are included in the consolidated statements of financial position and the related depreciation included in the consolidated statements of income;
- the determination of mineral reserve, carrying amount of mineral properties, and depletion of mineral properties included in the consolidated statements of financial position and the related depletion included in the consolidated statements of income;

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**r) Significant Accounting Judgments and Estimates (continued)**

*ii. Estimates (continued)*

- the determination of the fair value of financial instruments and derivatives included in the consolidated statements of financial position;
- the fair value estimation of share-based awards included in the consolidated statements of financial position and the inputs used in accounting for share-based compensation expense in the consolidated statements of income;
- the provision for income taxes which is included in the consolidation statements of income and composition of deferred income tax asset and liabilities included in the consolidated statement of financial position;
- the inputs used in determining the net present value of the liability for provisions related to decommissioning and restoration included in the consolidated statements of financial position;
- the inputs used in determining the various commitments and contingencies accrued in the consolidated statements of financial position; and,
- the assessment of indications of impairment of each mineral properties and related determination of the net realizable value and write-down of those properties where applicable.

**s) New Accounting Standards**

*i) New Accounting Standards Impacting on or after January 1, 2012*

**IFRS 7 Financial Instruments: Disclosures** (Amendment)

The amendment, effective for annual periods beginning on or after July 1, 2011, with early application permitted, requires additional quantitative and qualitative disclosures relating to transfers of financial assets, where: financial assets are derecognized in their entirety, but where the entity has a continuing involvement in them; financial assets that are not derecognized in their entirety.

**IAS 12 Income Taxes** (Amendment)

IAS 12 *Income Taxes*, amendments regarding Deferred Tax: Recovery of Underlying Assets introduces an exception to the existing principle for the measurement of deferred tax assets and liabilities arising on investment property measured at fair value, and the requirement that deferred tax on non-depreciable assets measured using the revaluation model in IAS 16 should always be measured on a sale basis. The amendment is effective for annual periods beginning on or after January 1, 2012.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**s) New Accounting Standards (continued)**

**ii) *New Accounting Standards Impacting on or after July 1, 2012***

**IAS 1 Presentation of Financial Statements (Amendment)**

The amendments to IAS 1 *Presentation of Financial Statements* require companies preparing financial statements in accordance with IFRSs to group together items within OCI that may be reclassified to the profit or loss section of the income statement. The amendments retain the 'one or two statement' approach at the option of the entity and only revise the way other comprehensive income is presented: requiring separate subtotals for those elements which may be 'recycled' (e.g. cash-flow hedging, foreign currency translation), and those elements that will not (e.g. fair value through OCI items under IFRS 9). In addition, the tax associated with items presented before tax to be shown separately for each of the two groups of OCI items (without changing the option to present items of OCI either before tax or net of tax).

The amendment is effective for annual periods beginning on or after July 1, 2012.

**iii) *New Accounting Standards Impacting on or after January 1, 2013***

**IFRS 10 Consolidated Financial Statements**

IFRS 10 *Consolidated Financial Statements* replaces the portion of IAS 27 *Consolidated and Separate Financial Statements* that addresses the accounting for consolidated financial statements, and SIC12 *Consolidation - Special Purpose Entities*. IFRS 10 establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more entities. This standard (i) requires a parent entity (an entity that controls one or more other entities) to present consolidated financial statements; (ii) defines the principle of control, and establishes control as a basis for consolidation; (iii) sets out how to apply the principle of control whether an investor controls an investee and therefore must consolidate the investee; and (iv) sets out the accounting requirements for the preparation of consolidated financial statements. IFRS 10 is effective for annual periods beginning on or after January 1, 2013, with early adoption permitted. IFRS 10 may be adopted to an earlier accounting period, but in doing so, an entity must disclose the fact that it has early adopted the standard and apply IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities*, IAS 27 *Separate Financial Statements* (as amended in 2011), IAS 28 *Investments in Associates and Joint Ventures* (as amended in 2011).

**IFRS 11 Joint Arrangements**

IFRS 11 replaces IAS 31 *Interest in Joint Ventures* and SIC-13 *Jointly-Controlled Entities – Non-Monetary Contributions by Venturers*. This standard establishes the core principle that a party to a joint arrangement determines the type of joint arrangement in which it is involved by assessing its rights and obligations and accounts for those rights and obligations in accordance with that type of joint arrangement (joint operations or joint ventures). This standard is effective for annual periods on or after January 1, 2013, with early adoption permitted.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)**

**s) New Accounting Standards (continued)**

**iii. New Accounting Standards Impacting January 1, 2013 (continued)**

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

IFRS 12 combines the disclosure requirements for an entity's interest in subsidiaries, joint arrangements, associates and structured entities into one comprehensive disclosure standard. This standard requires the disclosure of information that enable users of financial statements to evaluate the nature of, and risks associated with, its interest in other entities and the effects of those interests on its financial position, financial performance and cash flows. This standard is effective for annual periods beginning on or after January 1, 2013, with early adoption permitted, and entities are permitted to incorporate any of the new disclosures into their financial statements before that date.

**IFRS 13 Fair Value Measurement**

IFRS 13 *Fair Value Measurement* provides guidance on how to measure fair value, but does not change when fair value is required or permitted under IFRS. IFRS 13 defines fair value, sets out a single IFRS framework for measuring fair value and requires disclosures about fair value measurements. IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements), except for: share-based payment transactions within the scope of IFRS 2 *Share-based Payment*; leasing transactions with the scope of IAS 17 *Leases*; measurements that have some similarities to fair value that are not fair value, such as net realizable value in IAS 2 *Inventories*; or value in use IAS 36 *Impairment of Assets*. This standard is effective for annual periods beginning on or after January 1, 2013, with early adoption permitted.

**IAS 27 Separate Financial Statements**

IAS 27 has the objective of setting standards to be applied in accounting for investments in subsidiaries, jointly controlled entities, and associates when an entity elects, or is required by local regulations, to present separate (non-consolidated) financial statements. This standard is effective for annual periods beginning on or after January 1, 2013, with early adoption permitted. This standard will not have an impact on the consolidated financial statements.

**IAS 28 Investments in Associates and Joint Ventures**

IAS 28 prescribes the accounting for investments in associates and to set the requirements for the application of the equity method when accounting for investments in associates and joint ventures. This standard is effective for annual periods beginning on or after January 1, 2013, with early adoption permitted.

The Company anticipates that the application of these standards, amendments and interpretations will not have a material impact on the results and financial position of the Company.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**2. Basis of Consolidation and Summary of Significant Accounting Policies (continued)****s) New Accounting Standards (continued)****iv) New Accounting Standards Impacting on or after January 1, 2015****IFRS 9 Financial Instruments - Classification and Measurement**

On 12 November 2009, the IASB issued IFRS 9 *Financial Instruments* as the first step in its project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 retains but simplifies the mixed measurement model and establishes two primary measurement categories for financial assets: amortized cost and fair value. The basis of classification depends on an entity's business model and the contractual cash flow of the financial asset. Classification is made at the time the financial asset is initially recognized, namely when the entity becomes a party to the contractual provisions of the instrument.

IFRS 9 amends some of the requirements of IFRS 7 *Financial Instruments: Disclosures* including added disclosures about investments in equity instruments measured at fair value in OCI, and guidance on financial liabilities and de-recognition of financial instruments. IFRS 9 must be applied starting January 1, 2013 with early adoption permitted. We are currently assessing the impact of adopting IFRS 9.

On July 22, 2011, the IASB agreed to defer the mandatory effective date to annual periods beginning on or after January 1, 2015 with early application still permitted.

**3. Cash and Cash Equivalents**

	June 30, 2011		December 31, 2010	
Cash at bank and on hand	\$	29,649	\$	61,118
Short term bank deposits		34,129		9,180
	\$	63,778	\$	70,298

**4. Derivatives**

	June 30, 2011		December 31, 2010	
	Assets	Liabilities	Assets	Liabilities
Lead forward contracts	\$ -	\$ 178	\$ -	\$ 14
Zinc forward contracts	-	81	-	6
Silver forward contracts	1,313	-	-	113
Total	\$ 1,313	\$ 259	\$ -	\$ 133
Net	\$ 1,054		\$	133

The Company enters into forward commodity contracts as well as put and call option commodity arrangements to secure a minimum price level on part of its zinc and lead metal production. Additionally, for the unhedged balance of production, the Company enters regularly into short term forward and option metal contracts to fix the final settlement price of metal delivered in concentrates, where the final settlement price is yet to be set at a future quotational period according to contract terms.



**FORTUNA SILVER MINES INC.****NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)****4. Derivatives (continued)**

The forward sale and option contracts are settled against the arithmetic average of metal spot prices over the month in which the contract matures. No initial premium associated with these trades has been paid.

**5. Accounts Receivable and Other Assets and Deposits on Long Term Assets**

The current accounts receivables and other assets are comprised of the following:

	<b>June 30, 2011</b>	December 31, 2010
<b>Current</b>		
Trade receivables	\$ 6,750	\$ 11,224
Current portion of long term receivables - net	513	39
Prepaid expenses	759	903
Advances and other receivables	2,690	1,288
Accounts receivable and other assets	\$ 10,712	\$ 13,454
GST/HST and value added tax receivable	3,965	3,542
	\$ 14,677	\$ 16,996

Deposits on long term assets includes the non-current accounts receivable and other assets comprised of the following:

	<b>June 30, 2011</b>	December 31, 2010
<b>Non-current</b>		
Long term receivables	\$ 1,449	\$ 47
Less: current portion of long term receivables	(513)	(39)
Non-current portion of long term receivables - net	936	8
Deposits on equipment	4,508	3,097
Deposits paid to contractors	3,172	1,581
Other	555	-
	\$ 9,171	\$ 4,686

As at June 30, 2011, the Company had no trade receivables (2010: \$nil) which were past due and impaired. The Company's allowance for doubtful accounts is \$nil (2010: \$nil).

The aging analysis of these trade receivables is as follows:

	<b>June 30, 2011</b>	December 31, 2010
0-30 days	\$ 6,865	\$ 9,754
31-60 days	(519)	1,057
61-90 days	404	413
	\$ 6,750	\$ 11,224

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
 (Unaudited - All amounts in US\$'000's unless otherwise stated)

**6. Inventories**

	<b>June 30, 2011</b>		December 31, 2010
Concentrate stock piles \$	<b>905</b>	\$	346
Ore stock piles	<b>1,870</b>		1,274
Materials and supplies	<b>3,502</b>		2,398
<b>Total inventories \$</b>	<b>6,277</b>	\$	4,018

For the three and six months ended June 30, 2011, \$3,309 and \$11,814, respectively (2010: \$22,270) of inventory was expensed and there has been no impairment during 2011 (2010: \$nil).

**7. Mineral Properties, Property, Plant and Equipment**

	Mineral Properties	Land, Machinery and Equipment	Buildings, and Leasehold Improvements	Furniture and Other Equipment	Transport Units	Equipment under Finance Lease	Work in Progress	Total
<b>Period ended June 30, 2011</b>								
Opening carrying amount	\$ 82,737	\$ 6,897	\$ 7,013	\$ 3,177	\$ 112	\$ 2,893	\$ 14,534	\$ 117,363
Additions	14,219	8,445	163	462	59	499	15,145	38,992
Disposals	-	(1,530)	-	-	-	-	-	(1,530)
Depreciation charge	(1,981)	(777)	(394)	(133)	(53)	(385)	-	(3,723)
Reclassification	-	1,949	108	(1,895)	-	-	(3,956)	(3,794)
<b>Closing carrying amount</b>	<b>\$ 94,975</b>	<b>\$ 14,984</b>	<b>\$ 6,890</b>	<b>\$ 1,611</b>	<b>\$ 118</b>	<b>\$ 3,007</b>	<b>\$ 25,723</b>	<b>\$ 147,308</b>
<b>As at June 30, 2011</b>								
Cost	110,847	\$ 19,507	\$ 9,347	\$ 2,558	\$ 494	\$ 4,674	\$ 25,723	\$ 173,150
Accumulated depreciation and impairment	(15,872)	(4,523)	(2,457)	(947)	(376)	(1,667)	-	(25,842)
<b>Closing carrying amount</b>	<b>\$ 94,975</b>	<b>\$ 14,984</b>	<b>\$ 6,890</b>	<b>\$ 1,611</b>	<b>\$ 118</b>	<b>\$ 3,007</b>	<b>\$ 25,723</b>	<b>\$ 147,308</b>

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
 (Unaudited - All amounts in US\$'000's unless otherwise stated)

**7. Mineral Properties, Property, Plant and Equipment (continued)**

	Mineral Properties	Machinery and Equipment	Land, Buildings, and Leasehold Improvements	Furniture and Other Equipment	Transport Units	Equipment under Finance Lease	Work in Progress	Total
Year ended December 31, 2010								
Opening carrying amount	\$ 68,277	\$ 6,916	\$ 4,033	\$ 1,117	\$ 197	\$ 2,682	\$ 1,953	\$ 85,175
Additions due to business combinations	-	-	-	-	-	-	-	-
Additions	18,619	1,574	155	2,436	88	928	16,490	40,290
Disposals	(555)	(20)	(1)	(10)	(67)	-	-	(653)
Depreciation charge	(3,604)	(1,509)	(768)	(273)	(106)	(664)	-	(6,924)
Reclassification	-	(64)	3,594	(93)	-	(53)	(3,909)	(525)
Closing carrying amount	\$ 82,737	\$ 6,897	\$ 7,013	\$ 3,177	\$ 112	\$ 2,893	\$ 14,534	\$ 117,363
As at December 31, 2010								
Cost	96,629	\$ 11,060	\$ 9,076	\$ 3,985	\$ 436	\$ 4,174	\$ 14,534	\$ 139,894
Accumulated depreciation and impairment	(13,892)	(4,163)	(2,063)	(808)	(324)	(1,281)	-	(22,531)
Closing carrying amount	\$ 82,737	\$ 6,897	\$ 7,013	\$ 3,177	\$ 112	\$ 2,893	\$ 14,534	\$ 117,363

Mineral properties includes the provision for bonuses amounting to \$1,363 (2010: \$nil) which are payable upon commissioning of the San Jose mine to a director, a director and officer, and an officer. The provision for bonuses comprises of \$1,121 payable to key management and \$242 payable to a director. There is no expected reimbursement and the timing of the cash outflow is dependent on the commissioning of the San Jose mine. Refer to Note 9 Related Party Transactions and Note 11 Provisions for Other Liabilities and Charges.

In May 2011, the Company entered into an agreement to acquire a 100% interest in the Mario Property, located in the Department of Junin in central Peru. Under the terms of the agreement, the Company is granted the exclusive right and option to purchase an undivided 100% interest in the Mario Property subject to the following payments:

1. \$500 on signing of agreement;
2. \$500 on or before six months from the signing of the agreement;
3. \$500 on or before 12 months from the signing of the agreement; and,
4. \$2,500 on or before 24 months from the signing of the agreement.

The purchase of the property by the Company is subject to a 1% net smelter return ("NSR") royalty on production from the property payable to Crocodile Gold ("Crocodile"). The Company shall have the right to purchase the NSR royalty from Crocodile at any time during the five-year period following the final option payment for the sum of \$3,000. The property is also subject to a 2% NSR royalty on production payable to Teck Cominco and a 0.5% NSR royalty on production payable to Socrate Capital Inc., with each royalty in turn subject to certain buy-back provisions.

As at June 30, 2011, no amounts have been paid under the agreement.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
 (Unaudited - All amounts in US\$'000's unless otherwise stated)

**8. Trade and other payables**

	<b>June 30, 2011</b>	December 31, 2010
<b>Current</b>		
Trade accounts payable	\$ 6,533	\$ 3,967
Payroll and other payables	5,654	5,249
Restricted share unit payable	1,180	87
	<b>\$ 13,367</b>	<b>\$ 9,303</b>

**9. Related Party Transactions****a) Purchase of Goods and Services**

The Company entered into the following related party transactions:

<b>Transactions with related parties</b>	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2011</b>	2010	<b>2011</b>	2010
Salaries and wages <sup>1,2</sup>	\$ 69	\$ 26	\$ 96	\$ 55
Other general and administrative expenses <sup>2</sup>	46	39	93	119
	<b>\$ 115</b>	<b>\$ 65</b>	<b>\$ 189</b>	<b>\$ 174</b>

<sup>1</sup> Salaries and wages includes employees' salaries and benefits charged to the Company based on an estimated percentage of the actual hours worked for the Company.

<sup>2</sup> Radius Gold Inc. ("Radius") has directors in common with the Company and shares office space, and is reimbursed for salaries and wages, and various general and administrative costs incurred on behalf of the Company.

On January 14, 2011, the Company issued 6,756 (2010: 7,813) common shares, at a fair market value of \$4.44 (2010: \$2.56) per share and \$30 cash (2010: \$20) to Radius Gold, under the option to acquire a 60% interest in Tlacolula silver project located in the State of Oaxaca, Mexico.

**b) Key Management Compensation**

Key management includes all persons named or performing the duties of Vice-President, Chief Financial Officer, President, and the Chief Executive Officer of the Company. The compensation paid or payable to key management for employee services is shown below:

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2011</b>	2010	<b>2011</b>	2010
Salaries and other short term employee benefits	\$ 476	\$ 683	\$ 1,251	\$ 934
Provision for bonuses (Note 7)	1,121	-	1,121	-
Share-based payments	1,098	(867)	1,321	(867)
	<b>\$ 2,695</b>	<b>\$ (184)</b>	<b>\$ 3,693</b>	<b>\$ 67</b>

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
 (Unaudited - All amounts in US\$'000's unless otherwise stated)

**9. Related Party Transactions (continued)****b) Key Management Compensation (continued)**

The share-based payments includes the change in the RSU fair value period over period and for 2010 includes the non-cash cancellation of share options. During the six months ended June 30, 2011, 155,674 RSU were granted to the CEO with the restriction that the entire RSU vests only upon the commissioning of the San Jose mine.

**c) Period-end Balances arising from Purchases of Goods/Services**

<b>Amounts due to/(from) related parties</b>	<b>June 30, 2011</b>		<b>December 31, 2010</b>	
Owing from a director and officer <sup>3</sup>	\$	(63)	\$	(1)
Owing to a company with common directors <sup>2</sup>		49		41
Provision for bonuses (Note 7)		1,363		-
	\$	1,349	\$	40

<sup>3</sup> Owing from a director includes non-interest bearing advances to a director, an officer and a former officer at June 30, 2011 and one officer and director at December 31, 2010.

**d) Transactions with Directors**

Transactions with non-executive Directors is shown below:

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Directors fees	\$ 91	\$ 34	\$ 152	\$ 82
Consulting fees	46	44	92	87
Short term benefits	17	2	31	4
Provision for bonuses (Note 7)	242	-	242	-
Share-based payments	766	(958)	982	(958)
	\$ 1,162	\$ (878)	\$ 1,499	\$ (785)

The share-based payments includes the change in the DSU fair value period over period and payments made under the DSU plan and the non-cash cancellation of share options. During the three and six month periods ended June 30, 2011, share-based payments includes a DSU redemption of 70,000 units settled in cash for CAD\$5.30 per unit for a total payment of CAD\$371. In addition, 93,544 units were granted to a Director with the restriction that the entire DSU vests only upon the commissioning of the San Jose mine.

Consulting fees includes fees paid to two (2010: two) non-executive directors.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**10. Leases and Long Term Liabilities**

Leases and long term liabilities are comprised of the following:

	<b>June 30,</b>	December 31,
	<b>2011</b>	2010
Obligations under finance lease (a)	\$ 1,488	\$ 1,545
Long term liability (b)	737	705
Deferred share units (Note 12 c))	2,484	1,955
Restricted share units (Note 12 d))	1,370	131
	<b>6,079</b>	4,336
Less: current portion		
Obligations under finance lease	1,174	1,083
Long term liability	737	-
	<b>1,911</b>	1,083
Restricted share units (Note 8)	1,180	87
	<b>\$ 2,988</b>	\$ 3,166

**a) Obligations under Finance Lease**

The following is a schedule of the Company's future minimum lease payments. These are related to the acquisition of mining equipment, vehicles, and buildings.

	<b>June 30,</b>	December 31,
<b>Obligations under Finance Lease</b>	<b>2011</b>	2010
Not later than 1 year	\$ 1,225	\$ 1,150
Less future finance charges on finance lease	(51)	(67)
	<b>1,174</b>	1,083
Later than 1 year but less than 5 years	320	472
Later than 5 years	-	-
Less future finance charges on finance lease	(6)	(10)
	<b>314</b>	462
Present value of finance lease payments	\$ 1,488	\$ 1,545

**b) Long Term Liabilities**

In May 2008, the Company acquired the Monte Alban II concession for which a payment of \$800 is due May 2012. This payment is non-interest bearing.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

**11. Provisions**

A summary of the Company's provisions for other liabilities and charges is presented below:

	<b>Decommissioning and Restoration Liability</b>	<b>Bonus Provision for San Jose Mine Commissioning</b>	<b>Total</b>
Balance - January 1, 2010	\$ 2,917	\$ -	\$ 2,917
New provisions	1,583	-	1,583
Increase to existing provisions	125	-	125
Unwinding of discount	163	-	163
Exchange differences	93	-	93
Balance - December 31, 2010	\$ 4,881	\$ -	\$ 4,881
(Decrease) Increase to existing provisions	(22)	-	(22)
Unwinding of discount	81	-	81
Exchange differences	174	-	174
Provision for bonuses (Note 7)	-	1,363	1,363
<b>Total provisions</b>	<b>\$ 5,114</b>	<b>\$ 1,363</b>	<b>\$ 6,477</b>
<b>less current portion (Note 7)</b>	<b>-</b>	<b>(1,363)</b>	<b>(1,363)</b>
<b>Non current - June 30, 2011</b>	<b>\$ 5,114</b>	<b>\$ -</b>	<b>\$ 5,114</b>

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 decommissioning and restoration liability 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 properties, property, plant and equipment balance.

Provision for bonuses amounting to \$1,363 (2010: \$nil) are payable, upon commissioning of the San Jose mine, to a director, a director and officer, and an officer. The provision for bonuses comprises of \$1,121 payable to key management and \$242 payable to a director. There is no expected reimbursement and the timing of the cash outflow is dependent on the commissioning of the San Jose mine. Refer to Note 7 Mineral Properties, Property, Plant and Equipment and Note 9 Related Party Transactions.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**12. Share Capital****a) Unlimited Common Shares Without Par Value**

During the year ended December 31, 2010, the Company issued an aggregate of 26,507,500 common shares, under two bought deal financings, for gross proceeds of \$78,528. Net proceeds of \$73,919 after share issuance costs of \$4,609 were raised from the bought deal financings comprised of: 15,007,500 common shares at CAD\$2.30 per share, for net proceeds of \$31,135; and 11,500,000 common shares at CAD\$4.00 per share, for net proceeds of \$42,784.

During fiscal 2011, the Company issued 6,756 (2010: 7,813) common shares, at a fair market value of \$4.44 (2010: \$2.56) per share Radius Gold, under the option to acquire a 60% interest in Tlacolula silver project located in the State of Oaxaca, Mexico.

**b) Share Options**

The Company's stock option plan, approved by the shareholders on August 30, 2006 and accepted by the TSX Venture Exchange on October 16, 2006 provides a rolling maximum of the issuance of common treasury shares equal to up to ten percent of the issued and outstanding common shares with no vesting provisions. The exercise price of the optioned shares are no less than the market price, with a maximum term of ten years from grant. Shareholder approval of the Company's stock option plan was not obtained at the Company's annual general meeting held on June 23, 2010.

Shareholder approval of the Company's new Stock Option Plan (the "New Plan"), dated April 11, 2011, was obtained at the Company's annual general meeting held on May 26, 2011. The New Plan provides that the number of common shares of the Company issuable under the Plan, together with all of the Company's other previously established or proposed share compensation arrangements, may not exceed 12,200,000 shares, which equals 9.92% of the current total number of issued and outstanding common shares of the Company.

The Company uses the fair value method of accounting for share options granted to directors, officers, and employees.

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.



**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
 (Unaudited - All amounts in US\$'000's unless otherwise stated)

**12. Share Capital (continued)****b) Share Options (continued)**

The following is a summary of option transactions:

	<b>June 30, 2011</b>		<b>December 31, 2010</b>	
	<b>Shares (in 000's)</b>	<b>Weighted average exercise price (CAD\$)</b>	<b>Shares (in 000's)</b>	<b>Weighted average exercise price (CAD\$)</b>
Outstanding at beginning of the period	<b>4,551</b>	<b>\$ 1.51</b>	8,215	\$ 1.50
Granted	<b>1,792</b>	<b>4.46</b>	-	\$ -
Exercised	<b>(587)</b>	<b>0.92</b>	(1,000)	\$ 1.03
Cancelled	-	-	(2,665)	\$ 1.62
Outstanding at end of the period	<b>5,756</b>	<b>\$ 2.49</b>	4,551	\$ 1.51
Vested and exercisable at end of the period	<b>3,964</b>	<b>\$ 1.60</b>	4,551	\$ 1.51

The non-cash compensation recovery of \$2,440 recognized for the year ended December 31, 2010 is associated with the 2,665,000 share purchase options granted in the fourth quarter of 2009 and cancelled as shareholder approval was not obtained at the Company's annual general meeting held on June 23, 2010.

On June 9, 2011, 1,792,289 share purchase options were granted with an exercise price of CAD\$4.46 per share with a term of three years and vesting 25% within six months of grant date, 50% within 12 months of grant date, 75% within 18 months of grant date, and fully vested after 24 months of grant date. The share based compensation charge of \$282 recognized for the six months ended June 30, 2011 has been determined under the fair value method using the Black-Scholes option pricing model with the following assumptions:

	<b>Six months ended June 30,</b>	
	<b>2011</b>	<b>2010</b>
Risk-free interest rate	<b>1.91%</b>	<b>n/a</b>
Expected stock price volatility	<b>56.48%</b>	<b>n/a</b>
Expected term in years	<b>3</b>	<b>n/a</b>
Expected dividend yield	<b>0%</b>	<b>n/a</b>

The expected volatility assumption is based on the historical and implied volatility of the Company's Canadian dollar common share price on the Toronto Stock Exchange

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

**12. Share Capital (continued)****b) Share Options (continued)**

The following table summarizes information related to stock options outstanding and exercisable at June 30, 2011:

Exercise price in CAD\$	Number of outstanding share purchase options (in 000's)	Weighted average remaining contractual life of outstanding share purchase options (years)	Weighted average exercise price on outstanding share purchase options CAD\$	Exercisable share purchase options (in 000's)	Weighted average exercise price on exercisable share purchase options CAD\$
\$0.80 to \$0.99	1,081	7.2	\$ 0.85	1,081	\$ 0.85
\$1.00 to \$1.99	1,763	5.0	1.61	1,763	1.61
\$2.00 to \$4.46	2,912	4.0	3.63	1,120	2.30
\$0.80 to \$4.46	5,756	4.9	\$ 2.49	3,964	\$ 1.60

The weighted average remaining life of vested share purchase options at June 30, 2011 was 5.8 years (2010: 6.4 years).

Subsequent to June 30, 2011 to August 10, 2011, 258,000 share purchase options were exercised at prices ranging from CAD\$0.85 to CAD\$1.66 per share, resulting in issued and outstanding shares of 123,349,221.

**c) Deferred Share Units ("DSU") Cost**

During 2010, the Company implemented a DSU plan which allows for up to 1% of the number of shares outstanding from time to time to be granted to eligible directors. All grants under the plan are fully vested upon credit to an eligible directors' account.

During the second quarter ended June 30, 2011, 70,000 DSU were settled in cash for CAD\$5.30 per unit for a total payment of CAD\$371.

During the second quarter ended June 30, 2011, the Company granted 48,824 DSU with a market value of CAD\$232, at the date of grant, to a director, and 93,544 DSU with a market value of CAD\$473, at the date of grant, to a director, with vesting subject to the commissioning of the San Jose mine.

As at June 30, 2011, there are 481,465 (2010: 409,097) DSU outstanding with a fair value of \$2,484 (2010: \$1,955).

**FORTUNA SILVER MINES INC.****NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)****12. Share Capital (continued)****d) Restricted Share Units ("RSU") Cost**

During 2010, the Company implemented a RSU plan for certain employees or officers. The RSU entitle employees or officers to a cash payment after the end of a performance period of up to two years following the date of the award. The RSU payment will be an amount equal to the fair market value of the Company's common share on the five trading days immediately prior to the end of the performance period multiplied by the number of RSU held by the employee.

During the second quarter, the Company granted 155,674 RSU with a market value of CAD\$788, at the date of grant, to a director, with vesting subject to the commissioning of the San Jose mine.

As at June 30, 2011, there are 374,788 (2010: 219,114) RSU outstanding with a fair value of \$1,369 (2010: \$131).

**e) Earnings per Share****i. Basic**

Basic earnings per share is calculated by dividing the profit attributable to equity owners of the Company by the weighted average number of shares outstanding during the period.

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

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Net earnings available to equity owners	\$ 6,197	\$ 6,719	\$ 10,979	\$ 12,443
Weighted average number of shares (in '000's)	123,024	110,165	122,818	105,040
Basic earnings per share	\$ 0.05	\$ 0.06	\$ 0.09	\$ 0.12

**FORTUNA SILVER MINES INC.**
**NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010**  
 (Unaudited - All amounts in US\$'000's unless otherwise stated)
**12. Share Capital (continued)****e) Earnings per Share (continued)****ii. Diluted**

Diluted earnings per share is calculated by adjusting the weighted average number of shares outstanding to assume conversion of all potentially dilutive shares. The potentially dilutive shares relate to share options and warrants. A calculation is done to determine the number of shares that could have been acquired at fair value (determined as the average annual market share price of the Company's shares) based on the exercise prices of outstanding share options, share purchase warrants and convertible debentures. The number of shares calculated as above is compared with the number of shares that would have been issued assuming the exercise of the share options.

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

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Net earnings available to equity owners	\$ 6,197	\$ 6,719	\$ 10,979	\$ 12,443
Weighted average number of shares ('000's)	123,024	110,165	122,818	105,040
Effect of dilutive securities				
Incremental shares from share options	1,782	3,326	1,868	3,201
Weighted average diluted shares outstanding	124,806	113,491	124,686	108,241
Diluted earnings per share	\$ 0.05	\$ 0.06	\$ 0.09	\$ 0.11

**13. Supplemental Cash Flow Information**

	Note	Three months ended June 30,		Six months ended June 30,	
		2011	2010	2011	2010
<b>Non-cash Investing and Financing Activities:</b>					
Issuance of shares on purchase of mineral properties, property, plant and equipment	7	\$ -	\$ -	\$ 30	\$ 20

## **FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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### **14. Capital Disclosure**

The Company's objectives when managing capital are to provide shareholder returns through maximization of the profitable growth of the business and to maintain a degree of financial flexibility relevant to the underlying operating and metal price risks while safeguarding the Company's ability to continue as a going concern.

The capital of the Company consists of equity and bank loan, net of cash. The Board of Directors does not establish a quantitative return on capital criteria for management. The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets.

The management of the Company believes that the capital resources of the Company as at June 30, 2011, are sufficient for its present needs for the next 12 months. The Company is not subject to externally imposed capital requirements.

The Company's overall strategy with respect to capital risk management remained unchanged during the period.

### **15. Management of Financial Risk**

The Company's financial instruments are exposed to certain financial risks, including currency risk, credit risk, liquidity risk, interest risk, and price risk. The Company's Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework and reviews the Company's policies on an ongoing basis.

#### **a) Fair Value of Financial Instruments**

The carrying value of cash and cash equivalents, short term investments, accounts receivable, trade and other payables, and due to related parties approximate their fair value due to the relatively short periods to maturity and the terms of these financial instruments. Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgement and, therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The analysis of financial instruments that are measured subsequent to initial recognition at fair value can be categorized into Levels 1 to 3 based upon the degree to which the fair value is observable.

- Level 1 - inputs to the valuation methodology are quoted (unadjusted) for identical assets or liabilities in active markets.
- Level 2 - inputs to valuation methodology include quoted market prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 - inputs to the valuation methodology are unobservable and significant to the fair value of measurement.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

**15. Management of Financial Risk (continued)****a) Fair Value of Financial Instruments (continued)**

The Company has classified the determination of fair value of accounts receivable and derivatives as level 2, as the valuation method used by the Company includes an assessment of assets in quoted markets with significant observable inputs.

<b>Financial assets (liabilities) at fair value as at June 30, 2011</b>				
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash and cash equivalents	\$ 63,778	\$ -	\$ -	\$ 63,778
Short term investments	10,763	-	-	10,763
Accounts receivable	-	6,750	-	6,750
Derivatives	-	1,054	-	1,054
	<b>\$ 74,541</b>	<b>\$ 7,804</b>	<b>\$ -</b>	<b>\$ 82,345</b>

There were no changes in the levels during the period ended June 30, 2011.

<b>Financial assets (liabilities) at fair value as at December 31, 2010</b>				
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash and cash equivalents	\$ 70,298	\$ -	\$ -	\$ 70,298
Short term investments	20,509	-	-	20,509
Accounts receivable	-	12,551	-	12,551
Derivatives	-	(133)	-	(133)
	<b>\$ 90,807</b>	<b>\$ 12,418</b>	<b>\$ -</b>	<b>\$ 103,225</b>

There were no changes in the levels during the year ended December 31, 2010.

Accounts receivable includes accounts receivable from provisional sales. The fair value of accounts receivable resulting from provisional pricing reflect observable market commodity prices. Resulting fair value changes to accounts receivable are through sales. Transactions involving accounts receivable are with counterparties the Company believes are creditworthy.

Derivatives are carried at their fair value, which is determined based on internal valuation models that reflect observable forward market commodity prices. Resulting fair value changes to derivatives are through net gain (loss) on commodity contracts. Transactions involving derivatives are with counterparties the Company believes to be creditworthy.

During the period ended June 30, 2011, there have been no changes in the classification of financial assets and liabilities in level 3 of the hierarchy.

**FORTUNA SILVER MINES INC.****NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)****15. Management of Financial Risk (continued)****b) Currency Risk**

The Company is exposed to the financial risk related to the fluctuation of foreign exchange rates. The Company operates in Canada, Peru and Mexico and a portion of its expenses are incurred in Canadian dollars, Nuevo Soles, and Mexican Pesos. A significant change in the currency exchange rates between the United States dollar relative to the other currencies could have a material effect on the Company's income, financial position, or cash flows. The Company has not hedged its exposure to currency fluctuations.

As at June 30, 2011, the Company is exposed to currency risk through the following assets and liabilities denominated in Canadian dollars, Nuevo Soles and Mexican Pesos (all amounts are expressed in thousands of Canadian dollars, thousands of Nuevo Soles or thousands of Mexican Pesos):

	June 30, 2011			December 31, 2010		
	Canadian Dollars	Nuevo Soles	Mexican Pesos	Canadian Dollars	Nuevo Soles	Mexican Pesos
Cash and cash equivalents	\$ 28,977 S/.	790	\$ 885	\$ 54,782 S/.	741	\$ 2,201
Short term investments	10,514	-	-	-	-	-
Accounts receivable and other assets	54	2,799	45,291	71	1,304	42,452
Deposits on long term assets	-	-	65,317	-	-	24,209
Trade and other payables	(1,451)	(15,034)	(36,959)	(625)	(15,493)	(6,390)
Income tax payable	-	(9,251)	-	-	(11,775)	-
Leases and long term liabilities	(2,611)	-	-	(1,999)	-	-
Provisions	-	(8,981)	(20,093)	-	(9,169)	(19,959)

Based on the above net exposure as at June 30, 2011, and assuming that all other variables remain constant, a 10% depreciation or appreciation of the US dollar against the above currencies would result in an increase or decrease, as follows: impact to other comprehensive income of \$4,036 and a net loss of \$688.

**c) Credit Risk**

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its contractual obligations. The Company's cash and cash equivalents and short term investments are held through large Canadian, international and foreign national financial institutions. These investments mature at various dates within one year. All of the Company's trade accounts receivables are held with large international metals trading companies.

The Company holds derivative contracts with financial institutions and in this regard is exposed to counterparty risk. The Company mitigates this risk by transacting only with reputable financial institutions to minimize credit risk.

The Company's maximum exposure to credit risk at June 30, 2011 is as follows:

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
 (Unaudited - All amounts in US\$'000's unless otherwise stated)

**15. Management of Financial Risk (continued)****c) Credit Risk (continued)**

	<b>June 30, 2011</b>		December 31, 2010	
Cash and cash equivalents	\$	<b>63,778</b>	\$	70,298
Short term investments		<b>10,763</b>		20,509
Accounts receivable		<b>9,953</b>		12,551
Derivatives		<b>1,054</b>		-
GST/HST and value added tax receivable		<b>3,965</b>		3,542
	\$	<b>89,513</b>	\$	106,900

**d) Liquidity Risk**

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company manages liquidity risk by continuing to monitor forecasted and actual cash flows. The Company has in place a planning and budgeting process to help determine the funds required to support the Company's normal operating requirements on an ongoing basis and its development plans. The Company strives to maintain sufficient liquidity to meet its short term business requirements, taking into account its anticipated cash flows from operations, its holdings of cash, short term investments, and its committed liabilities.

The Company expects the following maturities of its financial liabilities (including interest), finance leases, and other contractual commitments:

	<b>Expected payments due by period as at June 30, 2011</b>					Total
	Less than 1 year	1 - 3 years	4 - 5 years	After 5 years		
Trade and other payables	\$ 13,367	\$ -	\$ -	\$ -	\$ -	13,367
Due to related parties	1,349	-	-	-	-	1,349
Derivatives	259	-	-	-	-	259
Income tax payable	3,364	-	-	-	-	3,364
Long term liability	1,962	2,994	-	-	-	4,956
Operating leases	476	832	692	317	-	2,317
	<b>\$ 20,777</b>	<b>\$ 3,826</b>	<b>\$ 692</b>	<b>\$ 317</b>	<b>\$ -</b>	<b>\$ 25,612</b>

**e) Interest Rate Risk**

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The risk that the Company will realize a loss as a result of a decline in the fair value is limited because the balances are generally held with major financial institutions in demand deposit accounts.

A 10% change in interest rates would cause a \$38 change in net earnings on an annualized basis.



**FORTUNA SILVER MINES INC.****NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)****15. Management of Financial Risk (continued)****f) Metal Price Risk**

The Company is exposed to metals price risk with respect to silver, gold, zinc, lead, and copper sold through its mineral concentrate products. The Company mitigates this risk by implementing price protection programs for some of its zinc and lead production through the use of derivative instruments. As a matter of policy, the Company does not hedge its silver production.

There is no material impact of the metals prices on the financial statements.

**16. Segmented Information**

The Company's operating segments are based on the reports reviewed by the senior management group that are used to make strategic decisions.

The Chief Executive Officer considers the business from a geographic perspective considering the performance of the Company's business units.

The segment information provided to the board for the reportable segments for the three and six month periods ended June 30, 2011 and 2010 are as follows:

<b>Reportable Segments</b>	<b>Corporate</b>	<b>Bateas</b>	<b>Cuzcatlan</b>	<b>Total</b>
<b>Three months ended June 30, 2011</b>				
Sales to external customers	\$ -	\$ 24,267	\$ -	\$ 24,267
Sales to internal customers	\$ 1,239	\$ -	\$ -	\$ 1,239
Cost of sales	\$ -	\$ 9,422	\$ -	\$ 9,422
Depreciation, depletion, and amortization	\$ 27	\$ 1,299	\$ -	\$ 1,326
Selling, general and administrative expenses	\$ 4,325	\$ 1,049	\$ (43)	\$ 5,331
Interest income	\$ 152	\$ 58	\$ 18	\$ 228
Interest expense	\$ 76	\$ 63	\$ -	\$ 139
Income (loss) before tax	\$ (4,567)	\$ 15,229	\$ 92	\$ 10,754
Income taxes	\$ 35	\$ 4,522	\$ -	\$ 4,557
Income (loss) for the period	\$ (4,602)	\$ 10,707	\$ 92	\$ 6,197
<b>Three months ended June 30, 2010</b>				
Sales to external customers	\$ -	\$ 14,421	\$ -	\$ 14,421
Sales to internal customers	\$ 108	\$ -	\$ -	\$ 108
Cost of sales	\$ -	\$ 7,507	\$ -	\$ 7,507
Depreciation, depletion, and amortization	\$ 34	\$ 1,479	\$ -	\$ 1,513
Selling, general and administrative expenses	\$ (568)	\$ 568	\$ -	\$ -
Interest income	\$ 65	\$ 44	\$ -	\$ 109
Interest expense	\$ -	\$ 72	\$ -	\$ 72
Income before tax	\$ 973	\$ 8,693	\$ -	\$ 9,666
Income taxes	\$ 2	\$ 2,945	\$ -	\$ 2,947
Income for the period	\$ 971	\$ 5,748	\$ -	\$ 6,719

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
 (Unaudited - All amounts in US\$'000's unless otherwise stated)

**16. Segmented Information (continued)**

<b>Reportable Segments</b>	<b>Corporate</b>	<b>Bateas</b>	<b>Cuzcatlan</b>	<b>Total</b>
<b>Six months ended June 30, 2011</b>				
Sales to external customers	\$ -	\$ 45,940	\$ -	\$ 45,940
Sales to internal customers	\$ 2,374	\$ -	\$ -	\$ 2,374
Cost of sales	\$ -	\$ 18,042	\$ -	\$ 18,042
Depreciation, depletion, and amortization	\$ 82	\$ 3,067	\$ -	\$ 3,149
Selling, general and administrative expenses	\$ 7,042	\$ 1,992	\$ (71)	\$ 8,963
Interest income	\$ 351	\$ 109	\$ 18	\$ 478
Interest expense	\$ 149	\$ 127	\$ -	\$ 276
Income (loss) before tax	\$ (7,513)	\$ 26,315	\$ 142	\$ 18,944
Income taxes	\$ 65	\$ 7,900	\$ -	\$ 7,965
Income (loss) for the period	\$ (7,578)	\$ 18,415	\$ 142	\$ 10,979
<b>Six months ended June 30, 2010</b>				
Sales to external customers	\$ -	\$ 31,797	\$ -	\$ 31,797
Sales to internal customers	\$ 216	\$ -	\$ -	\$ 216
Cost of sales	\$ -	\$ 15,427	\$ -	\$ 15,427
Depreciation, depletion, and amortization	\$ 64	\$ 2,966	\$ -	\$ 3,030
Selling, general and administrative expenses	\$ 721	\$ 1,272	\$ -	\$ 1,993
Interest income	\$ 99	\$ 82	\$ -	\$ 181
Interest expense	\$ -	\$ 148	\$ -	\$ 148
Income (loss) before tax	\$ (115)	\$ 18,815	\$ -	\$ 18,700
Income taxes	\$ 2	\$ 6,255	\$ -	\$ 6,257
Income (loss) for the period	\$ (117)	\$ 12,560	\$ -	\$ 12,443
<b>As at June 30, 2011</b>				
Total assets	\$ 53,844	\$ 91,832	\$ 107,352	\$ 253,028
Total liabilities	\$ 4,917	\$ 25,482	\$ 6,484	\$ 36,883
<b>As at December 31, 2010</b>				
Total assets	\$ 81,900	\$ 74,950	\$ 77,020	\$ 233,870
Total liabilities	\$ 3,404	\$ 24,794	\$ 3,082	\$ 31,280

For the three and six month periods ended June 30, 2011 and 2010, two customers, represented 100% of total sales to external customers in Peru and of the Company as follows:

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**16. Segmented Information (continued)**

<b>External Sales by Customer and Region</b>	<b>Three months ended June 30,</b>				<b>Six months ended June 30,</b>			
	<b>2011</b>		<b>2010</b>		<b>2011</b>		<b>2010</b>	
1	\$ 24,259	100%	\$ 8,479	59%	\$44,197	96%	\$ 20,488	64%
2	8	0%	5,942	41%	1,743	4%	11,309	36%
Bateas/Peru	\$ 24,267	100%	\$ 14,421	100%	\$45,940	100%	\$ 31,797	100%
Consolidated	\$ 24,267	100%	\$ 14,421	100%	\$45,940	100%	\$ 31,797	100%
% of total sales	100%		100%		100%		100%	

**17. Contingencies and Capital Commitments****a) Bank Letter of Guarantee**

The Caylloma mine closure plan was approved in November 2009 with total closure costs of \$3,587 of which \$1,756 is subject to annual collateral in the form of a letter of guarantee, to be awarded each year in increments of \$146 over 12 years based on the estimated life of the mine.

Banco Bilbao Vizcaya Argentaria, S.A., a third party, has established a bank letter of guarantee on behalf of Bateas in favor of the Peruvian mining regulatory agency in compliance with local regulation associated with the approved Bateas' mine closure plan, for the sum of \$293. This bank letter of guarantee expires 360 days from December 2010.

Banco Bilbao Vizcaya Argentaria, S.A., has also established bank letters of guarantee totalling \$54 to provide an annual guarantee associated with an office lease contract and truck rentals. These bank letters of guarantee were renewed in June 2011 with expiry 360 days to June 2012.

**b) Capital Commitments**

As at June 30, 2011, capital commitments not disclosed elsewhere in the condensed interim consolidated financial statements include the development of the San Jose property located in Mexico of which \$15,845 forecasted to be expended within one year.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**17. Contingencies and Capital Commitments (continued)****c) Other Commitments**

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 the Company 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 annually by the energy market regulator in accordance with applicable regulations in Peru.

The Company acts as guarantor to finance lease obligations held by two of its mining contractors. These finance lease contracts are related to the acquisition of mining equipment deployed at the Caylloma mine. As at June 30, 2011, these obligations amounted to \$421 with \$63 and \$358 maturing in 2011 and 2012, respectively.

The Company, jointly with Radius Gold Inc., has entered into an office premises lease that will commence the earliest of January 1, 2012 or the date on which the Company commences carrying on business in the premises. The lease term is eight years with annual net rent payable, on 6,389 rentable square feet, is as follows:

- year one CAD\$35 per square feet for an obligation of CAD\$224 per annum;
- years three to five CAD\$36.00 per square feet for an obligation of CAD\$230per annum; and
- years six to eight CAD\$37 per square feet for an obligation of CAD\$236 per annum.

In addition, estimated operating costs, utilities and realty taxes is CAD\$145 in the first year of occupancy. The share arrangement with Radius has not yet been finalized but is not expected to be more than 50% of the total rent payable. As at June 30, 2011, the Company has advanced 50% of the three month security deposit in the amount of \$49 (CAD\$48).

**18. Subsequent Event up to August 10, 2011**

Subsequent to June 30, 2011, the Company entered into an option agreement, effective July 20, 2011, to acquire 100% interest in the Don Mario property, with Consorcio Empresarial Agmin S.A.C. ("AGMIN"). Under the terms of the mining assignment and option to purchase mineral rights agreement ("agreement"), the Company is required to make the following payments;

1. \$200 on signing the agreement;
2. \$300 after 12 months from signing the agreement;
3. \$500 after 24 months from signing the agreement; and,
4. \$2,000 after 36 months from signing the agreement.

Under the terms of the agreement, once the option is exercised and a NI 43-101 is prepared and published, if the pre-feasibility study indicates that the property contains more than five million silver equivalent ounces, the Company would further pay AGMIN, one dollar for each additional resource and reserves indicated in the pre-feasibility report. The Company has the option to buy-out the additional pay-out for a further \$3,000, subject to certain conditions. The Company has paid \$200 on signing the agreement.

## **FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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### **19. First-time Adoption of IFRS**

IFRS 1 *First-time Adoption of International Financial Reporting Standards*, which governs the first-time adoption of IFRS, in general requires accounting policies to be applied retrospectively to determine the opening financial position at the Company's transition date of January 1, 2010, and allows certain exemptions on the transition to IFRS. The elections the Company has decided to apply and that are considered significant to the Company include:

- not to restate previous business combinations;
- not to apply IFRS 2 to share-based payment transactions vested before January 1, 2010;
- reset the cumulative translation difference account to zero on transition;
- apply IAS 23 "Borrowing Costs" effective, January 1, 2010; and,
- apply IFRIC 1, Changes in Existing Decommissioning, Restoration and Similar Liabilities as of January 1, 2010. This avoids the requirement to recalculate the liability retrospectively from the date of recognition and then remeasure it at each subsequent reporting period up until the date of transition.

The IFRS 1 mandatory exceptions applied by the Company in the conversion from Canadian GAAP to IFRS included estimates. In accordance with IFRS 1, an entity's estimates under IFRS at the date of transition to IFRS must be consistent with estimates made for the same date under previous GAAP unless those estimates were in error. The Company's IFRS estimates as at the Transition Date are consistent with its Canadian GAAP estimates as at that date.

#### **Adjustments on transition to IFRS**

Adoption of IFRS resulted in changes to the Company's Statements of Financial Positions, Statements of Income, Statements of Comprehensive Income (Loss), Statements of Cash Flow, and Statements of Changes in Equity as set out below:

##### **a) Foreign Exchange**

Under IAS 21, each entity in a group must be analyzed, through application of primary and secondary factors, to determine its functional currency. Based on this assessment, the functional currency of each of the entities in the group is the US\$, with the exception of the parent entity and certain holding companies which have a Canadian dollar functional currency. Under Canadian GAAP, the parent entity had a Canadian dollar measurement currency and all subsidiaries were integrated with the exception of Bateas which was self-sustaining. The presentation currency will continue to be US\$.

The Group uses the direct consolidation whereby, the parent entity and the holding Companies which will have a CAD\$ functional currency will be translated to US\$ using the closing rate method with the differences to the cumulative translation adjustment account. Those entities with a US\$ functional currency don't require translation. Under Canadian GAAP, the Group used the indirect consolidation method whereby all entities were first translated to CAD\$ and then the entire consolidation translated to US\$ for presentation purposes.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**19. First-time Adoption of IFRS (continued)**

**Adjustments on transition to IFRS (continued)**

**b) Deferred Income Tax**

Under IFRS, income taxes include all domestic and foreign taxes based on taxable profits. The Company accounted for Peruvian statutory workers participation under Canadian GAAP as an income tax. Under IFRS the statutory workers participation is accounted for as an employee benefit under IAS 19. Accordingly, future Peruvian Workers Participation balances have been derecognized and Current Workers Participation expense has been reclassified from income tax expense to operating expenses.

Under IFRS, deferred tax is recognized on the difference between the accounting basis and tax basis of all items. Under Canadian GAAP income tax assets or liabilities were not recognized for differences arising between the historical exchange rate and the current exchange rate translation of the cost of non-monetary assets or liabilities of integrated foreign operations.

For foreign currency non-monetary assets or liabilities where the tax basis currency differs from the functional currency of the entity, foreign exchange differences will result in tax assets or liabilities which were not previously recognized under Canadian GAAP. This difference will result in added volatility in the tax expense as foreign exchange rate changes will have an impact on the tax expense.

IAS 12 does not permit recognition of temporary differences on the initial acquisition of assets that do not constitute a business combination. There is no similar prohibition under Canadian GAAP. Deferred tax arising from temporary differences on initial recognition have been reversed against mineral properties, property, plant and equipment and retained earnings.

**c) Reset Accumulated Other Comprehensive Income to Zero**

The Company has taken the exemption under IFRS1 which allows for the cumulative translation differences that existed at the date of transition to IFRS to be reset to zero.

**d) Provisions for other liabilities and charges**

Where a provision is recognized, IFRS requires the estimate to be discounted at a risk-free pre-tax rate, typically that of a government bond that is matched to the expected risk adjusted cash flows. On transition, the Company used a risk free rate to discount their decommissioning liabilities and this results in an increased decommissioning liability being recognized under IFRS as compared to Canadian GAAP.

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

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**19. First-time Adoption of IFRS (continued)****Adjustments on transition to IFRS (continued)****e) Reclassification of items in the Statement of Income**

The Company has reclassified the following income and expense items in the consolidated statements of income:

- government royalties to sales from selling, general and administrative expenses;
- distribution costs to cost of sales from selling, general and administrative expenses;
- community relation costs to cost of sales from selling, general and administrative expenses;
- other income and expenses from interest and other income and expenses to selling, general and administrative expenses;
- exploration and evaluation costs moved from selling, general and administrative expenses;
- interest expense includes interest on debt financing and unwinding of discount;
- current workers participation from income tax to cost of sales and selling, general and administrative expenses; and,
- depletion and depreciation combined with cost of sales.

The above changes are reclassifications within our statement of income so there is no net impact to our income as a result of these changes.

**f) Reconciliation of Consolidated Equity**

The reconciliations between the Canadian GAAP and IFRS consolidated Equity are provided below:

<b>Expressed in \$ '000's</b>	<b>June 30, 2010</b>	<b>December 31, 2010</b>
Shareholders' Equity, Canadian GAAP	\$ 153,339	\$ 206,008
Adjustments:		
Effect of foreign exchange on inventory, deposits on long term assets, and mineral properties, property, plant and equipment	19 a) (2,375)	(5,339)
Deferred income tax adjustments	19 b) 2,009	1,944
Transfer of accumulated other comprehensive income to retained earnings (deficit)	19 c) 2,898	2,898
Reset accumulated other comprehensive income to zero	19 c) (2,898)	(2,898)
Adjustment to revise provisions	19 d) (303)	(254)
Adjustment for depletion on mineral properties related to provisions	19 d) 204	231
<b>Total IFRS adjustments to Equity</b>	<b>(465)</b>	<b>(3,418)</b>
<b>Equity, IFRS</b>	<b>\$ 152,875</b>	<b>\$ 202,590</b>

Note: There may be differences due to rounding of decimal places

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
(Unaudited - All amounts in US\$'000's unless otherwise stated)

**19. First-time Adoption of IFRS (continued)****g) Reconciliation of Consolidated Statements of Financial Position**

The reconciliations between the Canadian GAAP and IFRS consolidated statements of financial position at December 31, 2010 (date of transition to IFRS) are provided below.

		<b>December 31, 2010</b>		
	<b>Notes</b>	<b>Canadian GAAP</b>	<b>Effect of Transition to IFRS</b>	<b>IFRS</b>
<b>ASSETS</b>				
<b>CURRENT ASSETS</b>				
Cash and cash equivalents		\$ 70,298	\$ -	\$ 70,298
Short term investments		20,509	-	20,509
Accounts receivable and other assets		13,454	-	13,454
GST/HST and value added tax receivable		3,542	-	3,542
Inventories	<b>19 a)</b>	4,034	(16)	4,018
		111,837	(16)	111,821
<b>NON-CURRENT ASSETS</b>				
Deposits on long term assets	<b>19 a)</b>	4,533	153	4,686
Mineral properties, property, plant and equipment	<b>19 a) b) d)</b>	126,813	(9,450)	117,363
<b>Total assets</b>		<b>\$243,183</b>	<b>\$ (9,313)</b>	<b>\$ 233,870</b>
<b>LIABILITIES AND EQUITY</b>				
<b>CURRENT LIABILITIES</b>				
Trade and other payables		\$ 9,303	\$ -	\$ 9,303
Due to related parties		40	-	40
Derivatives		133	-	133
Income tax payable		4,192	-	4,192
Current portion of long term liability		1,083	-	1,083
		14,751	-	14,751
<b>NON-CURRENT LIABILITIES</b>				
Leases and long term liabilities		3,166	-	3,166
Provisions for other liabilities and charges	<b>19 d)</b>	4,924	(43)	4,881
Deferred income tax liabilities	<b>19 b) d)</b>	14,334	(5,852)	8,482
		37,175	(5,895)	31,280
<b>EQUITY</b>				
Common shares		180,403	-	180,403
Share option and warrant reserve		11,116	-	11,116
Retained earnings (deficit)	<b>19 a) b) c) d)</b>	3,597	4,751	8,348
Accumulated other comprehensive income	<b>19 c)</b>	10,892	(8,169)	2,723
		14,489	(3,418)	11,071
		206,008	(3,418)	202,590
		\$243,183	\$ (9,313)	\$ 233,870



**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
 (Unaudited - All amounts in US\$'000's unless otherwise stated)

**19. First-time Adoption of IFRS (continued)****h) Reconciliations of Consolidated Statements of Income**

The reconciliation between the Canadian GAAP and IFRS consolidated statements of income for the three and six month periods ended June 30, 2010 are provided below:

	Notes	Three months ended June 30, 2010		Six months ended June 30, 2010			
		CAD GAAP	Effect of Transition to IFRS	IFRS	CAD GAAP	Effect of Transition to IFRS	IFRS
Sales	19 e)	\$ 14,565	(144)	\$ 14,421	\$ 32,108	(311)	\$ 31,797
Cost of sales	19 d) e)	6,569	938	7,507	13,347	2,080	15,427
<b>Mine operating income</b>		7,996	(1,082)	6,914	18,761	(2,391)	16,370
<b>Other expenses</b>							
Selling, general and administrative expenses	19 a) e)	1,208	(1,208)	-	4,268	(2,275)	1,993
Exploration and evaluation costs	19 e)	173	-	173	242	-	242
Net gain on commodity contracts		(2,895)		(2,895)	(4,642)		(4,642)
Loss on disposal of mineral properties, property, plant and equipment		7		7	110		110
<b>Operating income</b>		9,503	126	9,629	18,783	(116)	18,667
<b>Finance items</b>							
Interest income	19 d) e)	17	92	109	153	28	181
Interest expense	19 e)	(31)	(41)	(72)	(68)	(80)	(148)
<b>Net finance income (expense)</b>		(14)	51	37	85	(52)	33
<b>Income before tax</b>		9,489	177	9,666	18,868	(168)	18,700
Income taxes	19 b) d) e)	3,509	(562)	2,947	7,592	(1,335)	6,257
<b>Income for the period</b>		\$ 5,980	\$ 739	\$ 6,719	\$ 11,276	\$ 1,167	\$ 12,443

**FORTUNA SILVER MINES INC.**

NOTES TO THE CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2011 AND 2010  
 (Unaudited - All amounts in US\$'000's unless otherwise stated)

**19. First-time Adoption of IFRS (continued)****i) Reconciliations of Consolidated Statements of Comprehensive Income**

The reconciliation between the Canadian GAAP and IFRS consolidated statements of comprehensive income for the three and six month periods ended June 30, 2010 are provided below:

	Notes	Three months ended June 30, 2010		Six months ended June 30, 2010			
		CAD GAAP	Effect of Transition to IFRS	IFRS	CAD GAAP	Effect of Transition to IFRS	IFRS
Income for the period		\$ 5,980	\$ 739	\$ 6,719	\$ 11,276	\$ 1,167	\$ 12,443
Other comprehensive income (loss)							
Transfer of unrealized loss to realized loss upon reduction of net investment, net of taxes	19 c)	556	(556)	-	556	(556)	-
Unrealized gain on translation of functional currency to reporting currency	19 a)	(2,948)	1,650	(1,298)	(179)	120	(59)
Other comprehensive (loss) income		(2,392)	1,094	(1,298)	377	(436)	(59)
Total comprehensive income for the period		\$ 3,588	\$ 1,833	\$ 5,421	\$ 11,653	\$ 731	\$ 12,384

**j) Reconciliation of Consolidated Statements of Cash Flows**

The adoption of IFRS has had no material impact on the net cash flows of the Company. The changes made to the Consolidated Statements of Financial Position and Consolidated Statements of Comprehensive Income has resulted in reclassifications of various amounts on the Consolidated Statements of Cash Flows, however as there have been no material changes to the net cash flows, condensed reconciliations have been presented below.

	Notes	Six months ended June 30, 2010		
		CAD GAAP	Effect of Transition to IFRS	IFRS
Effect of exchange rate changes on cash and cash equivalents	19 a)	(222)	301	79
<b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	19 a)	18,344	(301)	18,043
Cash and cash equivalents - beginning of year		30,763	-	30,763
<b>CASH AND CASH EQUIVALENTS - END OF PERIOD</b>		\$ 48,885	\$ -	\$ 48,885



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**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**FOR THE**  
**SECOND QUARTER ENDED JUNE 30, 2011**

*As at August 10, 2011*

*(Dollar amounts expressed in US dollars, unless otherwise indicated)*

## **FORTUNA SILVER MINES INC.**

### **Management's Discussion and Analysis**

**For the second quarter ended June 30, 2011**

**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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*Management's Discussion and Analysis ("MD&A") is intended to help the reader understand the significant factors that have affected Fortuna Silver Mines Inc. and its subsidiaries' ("Fortuna" or the "Company") performance and such factors that may affect its future performance. For a comprehensive understanding of Fortuna's financial condition and results of operations, this MD&A should be read in conjunction with the Company's unaudited condensed interim consolidated financial statements for three and six month periods ended June 30, 2011 and the related notes contained therein. The Company reports its financial position, results of operations and cash flows in accordance with IAS 34, Interim Financial Reporting with the International Financial Reporting Standards ("IFRS") IFRS framework. In addition, the following should be read in conjunction with the Consolidated Financial Statements of the Company for the year ended December 31, 2010, the related MD&A, and Fortuna's Annual Information Form (available on SEDAR at [www.sedar.com](http://www.sedar.com)). This MD&A refers to various non-GAAP measures, such as cash cost per tonne of processed ore, cash cost per ounce of payable silver, adjusted net income (loss), cash generated by operating activities before changes in working capital, used by the Company to manage and evaluate operating performance and ability to generate cash and are widely reported in the silver mining industry as benchmarks for performance. Cash costs are presented as they represent an industry standard method of comparing certain costs on a per unit basis. The Company believes that certain investors use these non-GAAP measures to evaluate the Company's performance. Non-GAAP measures do not have standardized meaning. Accordingly, non-GAAP measures should not be considered in isolation or as a substitute for measures of performance prepared in accordance with GAAP. To facilitate a better understanding of these measures as calculated by the Company, we have provided detailed descriptions and reconciliations where applicable.*

***This document contains forward-looking statements. Please refer to the cautionary language under the heading "Cautionary Statement on Forward-Looking Information".***

### **Business of the Company**

Fortuna Silver Mines Inc. (the "Company") is a mining company focused on producing silver and base metals and developing silver projects in Latin America. The Company's principal assets are the Caylloma Polymetallic Mine in southern Peru and the San Jose Silver-Gold Project in southern Mexico.

### **Recent Developments and 2011 Highlights**

#### *First-Time Adoption of International Financial Reporting Standards ("IFRS")*

Note 19 to the condensed interim consolidated financial statements, along with further discussions below, provides more detail on our key Canadian GAAP to IFRS differences; our accounting policy decisions and IFRS 1, First-Time Adoption of International Financial Reporting Standards, optional exemptions for significant or potentially significant areas that have had an impact on our financial statements on transition to IFRS or may have an impact in future periods.

Information for 2009 is presented in accordance with Canadian GAAP and was not required to be restated to IFRS.

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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*Financial Results*

During the second quarter of 2011, the Company generated a net income of \$6.20 million (2010: \$6.72 million) on operating income of \$10.67 million (2010: \$9.63 million) and sales of \$24.27 million (2010: \$14.42 million).

Silver ounces produced during the second quarter ended June 30, 2011 were 474,979 (2010: 470,310) ounces, 1% above the same period in the prior year.

Silver comprised 63% (2010: 48%) of revenue and the realized silver price was \$36.87 (2010: \$17.36) per ounce. Cash cost per ounce, net of by-product credits, was negative \$4.42 (2010: negative \$3.83). See the Page 11 for reconciliation of cash cost to the cost of sales.

Cash generated by operating activities before changes in working capital, income taxes, and interest income (a non-GAAP measure) for the second quarter ended June 30, 2011 totalled \$12.22 million, up from \$6.97 million in 2010.

*Property Option Agreement (refer Sedar.com for release dated May 30, 2011)*

In May 2011, the Company entered into an agreement to acquire a 100% interest in the Mario Property, located in the Department of Junin in central Peru. Under the terms of the agreement, the Company is granted the exclusive right and option to purchase an undivided 100% interest in the Mario Property subject to the following payments:

1. \$0.50 million on signing of agreement;
2. \$0.50 million on or before six months from the signing of the agreement;
3. \$0.50 million on or before 12 months from the signing of the agreement; and,
4. \$2.50 million on or before 24 months from the signing of the agreement.

The purchase of the property by the Company is subject to a 1% net smelter return ("NSR") royalty on production from the property payable to Crocodile Gold ("Crocodile"). The Company shall have the right to purchase the NSR royalty from Crocodile at any time during the five year period following the final option payment for the sum of US\$3.00 million. The property is also subject to a 2% NSR royalty on production payable to Teck Cominco and a 0.5% NSR royalty on production payable to Socrate Capital Inc., with each royalty in turn subject to certain buy-back provisions.

As at June 30, 2011, no amounts have been paid under the agreement.

Subsequent to June 30, 2011, the Company entered into an option agreement, effective July 20, 2011, to acquire 100% interest in the Don Mario property, with Consorcio Empresarial Agmin S.A.C. ("AGMIN"). Under the terms of the mining assignment and option to purchase mineral rights agreement ("agreement"), the Company is required to make the following payments:

1. \$0.20 million on signing the agreement;
2. \$0.30 million after 12 months from signing the agreement;
3. \$0.50 million after 24 months from signing the agreement; and,
4. \$2.00 million after 36 months from signing the agreement.

Under the terms of the agreement, once the option is exercised and a NI 43-101 is prepared and published, if the pre-feasibility study indicates that the property contains more than five million silver equivalent ounces, the

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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Company would further pay AGMIN, one dollar for each additional resource and reserves indicated in the pre-feasibility report. The Company has the option to buy-out the additional pay-out for a further \$3.0 million, subject to certain conditions. The Company has paid \$0.20 million on signing the agreement.

*Corporate Highlights*

On April 19, 2011, the Company announced changes to the Board of Directors with the appointment of Thomas Kelly and the resignation of Jeffrey Franzen.

On May 26, 2011, Jorge Ganoza Aicardi, resigned as Vice-President, Operations. Effective August 1<sup>st</sup>, 2011 Manuel Ruiz-Conejo, previously Vice-President Project Development, was appointed to the position.

*San Jose Mine Construction*

At the San Jose project, construction activities are on-time and budget. The Company plans to declare the start of commercial operations on September 1<sup>st</sup> 2011. Commissioning of the processing plant began in mid July, 15 days ahead of schedule. The 8MW power substation, tailings dam and crushing circuit have already been commissioned.

To the end of June 30, 2011, \$44.10 million had been invested in construction.

*San Jose Updated Mine Plan (refer to Sedar.com for release dated June 1, 2011)*

Based on the mineral reserves reported in the release dated April 12, 2011, an updated optimized mine plan for San Jose, in Mexico is highlighted below:

- 3.8 million tonnes of probable reserves with 24.5 million ounces of contained silver and 191,600 ounces of contained gold at average grades of 202 g/t Ag and 1.58 g/t Au.
- Start-up production rate of 1,000 tpd compared to 750 tpd as stated in the pre-feasibility study ("PFS") news release published in April of 2010.
- Ramp-up to design capacity of 1,500 tpd by the fourth quarter of 2013 compared to the beginning of 2016 as stated in the PFS news release published in April of 2010.
- Total metal production from 2011 to 2019 of 21.6 million ounces of silver and 172,815 ounces of gold.
- Life of mine average cash cost per silver ounce net of by-product credits of US\$2.84 or US\$7.84 per silver equivalent ounce.
- 3.1 million tonnes of inferred resources with 22 million ounces of contained silver and 178,000 ounces of contained gold at average grades of 222 g/t Ag and 1.80 g/t Au, not included in the reserves or the economic model. Management expects to upgrade and convert these inferred resources to reserves as it is typical for an operating mine.

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

**Quarterly Information**

The following table provides information for the eight fiscal quarters ended June 30, 2011:

Expressed in \$000's, except per share data <sup>*/**</sup>	Quarters ended							
	30-Jun-11	31-Mar-11	31-Dec-10	30-Sep-10	30-Jun-10	31-Mar-10	31-Dec-09	30-Sep-09
<b>Sales</b>	<b>24,267</b>	21,673	23,589	17,882	14,421	17,376	16,356	13,230
<b>Operating income</b>	<b>10,665</b>	8,077	7,956	688	9,629	9,038	5,563	4,388
<b>Income before taxes</b>	<b>10,754</b>	8,190	8,033	780	9,666	9,034	3,189	750
<b>Income (loss)</b>	<b>6,197</b>	4,782	4,333	(773)	6,719	5,724	1,037	(556)
<b>Earnings (loss) per share, basic</b>	<b>0.05</b>	0.04	0.04	(0.01)	0.06	0.06	0.01	(0.01)
<b>Total assets</b>	<b>253,028</b>	242,548	233,870	180,376	175,445	169,565	139,738	131,372
<b>Leases and long term liabilities</b>	<b>2,988</b>	3,384	3,166	2,653	1,384	1,306	1,454	1,524

\* Figures for 2011 and 2010 expressed under IFRS

\*\* Figures for 2009 expressed under Canadian GAAP

In Q2 2011, the Company achieved record sales of \$24.27 million attributable mainly to a strong silver price environment. Sales in Q2 2011 increased by 12% to \$24.27 million from \$21.67 million in Q1 2011 mainly as a result of a 23% increase in realized silver prices and an 8% increase in metal silver sold. Operating income in Q2 2011 increased by 32% compared to Q1 2011 primarily as a result of higher sales and the gain on commodity contracts of \$1.44 million (Q1 2011 loss of \$1.01 million) partially offset by higher selling, general and administrative expenses in Q2 2011 of \$5.33 million compared to \$3.63 million in Q1 2011.

Sales in the first quarter of 2011 declined by 8% compared to Q4 2010. This decline is a result of a reduction in metal sold (silver 14%, lead 17%, and zinc 16%) offset by an increase in realized prices for all metals (silver 19%, lead 8%, and zinc 11%). The reduction in metal sold is explained by a decline in metal production and an inventory build-up equivalent to 6% of production for the period. In addition, in January 2011, copper production which represented 3% of sales in Q4 2010 was discontinued at Caylloma due to a material deterioration in concentrate commercial terms with respect to 2010.

Even though the Company achieved higher sales in Q4 and Q3 2010 as compared to Q2 2010, there was a reduction of net income primarily as result of the following: net losses on commodity contracts of \$0.73 million in Q4 2010 and \$3.18 million in Q3 2010 compared to a gain of \$2.90 million in Q2 2010; share-based compensation expense of \$0.76 million and \$1.22 million in Q4 and Q3 2010, compared to a recovery of \$2.40 million in Q2 2010; higher production cash cost of 14% for Q4 and 10% for Q3; and, a write off of deferred exploration costs in Q3 2010 of \$0.44 million.

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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**Results of Operations**

*San Jose Mine Construction*

*Construction Highlights*

- The Company plans to declare the start of commercial operations on September 1<sup>st</sup>, 2011.
- Processing plant construction for start up at 1,000 tpd is 100% complete and commissioning is underway.
- Three stage crushing circuit has been commissioned and a stockpile of crushed ore of 6,500 t had been accumulated up to the third week of July, 2011.
- Tailings dam has been commissioned and is currently storing water for the process.
- New 8MW power substation is in operation and sourcing power to the project.
- Mining of stopes K, L and M commenced in late July 2011. The production plan is in line to source 520,613 ounces Ag and 4,584 ounces Au or 782,851 ounces Ag Eq\* in 2011 and 1.7 million ounces Ag and 15,326 ounces Au or 2.6 million ounces Ag Eq\* in 2012.
- As at the end of June 2011, the mine had built a development ore stockpile of 44,989 tonnes grading 126 g/t Ag and 1.17 g/t Au.  
(\* ) 2011 Ag Eq based on US\$23.60 / oz Ag and US\$1,350 / oz Au. 2012 Ag Eq based on US\$23.10 / oz Ag and US\$1,340 / oz Au.

*Construction Update*

*Processing Plant and Ancillary Facilities*

The commissioning of the processing plant is in progress with the mill currently being tested running ore along the full processing circuit.

Construction of ancillary facilities such as the administrative offices, general warehouse and assay laboratory among others is 97% complete.

*Underground Mine Development*

As of the end of June 2011, the main ramp reached below the 1400 meter elevation and is expected to reach sub-level 1350 by the end of 2011, where production blocks A and B will be prepared. Production blocks K, L and M have already been prepared for start-up of production in July 2011 at an initial mining rate of 1,000 tpd. Stopping in blocks K and M started in late July 2011 according to plan.

The grade and tonnage in these production areas is consistent with the resource model.

As of June 30, 2011 the mine had built a development ore stockpile of 44,989 tonnes grading 126 g/t Ag and 1.17 g/t Au.



**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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*Water Sourcing*

As of the end of June, make-up water balance for the operation is being met by precipitation captured in the project's water reservoirs. Final stage negotiations are ongoing to install the remaining two kilometers of the water pipeline from the Ocotlan grey water treatment plant to the mine site.

*Power Substation*

In April 2011, the 8MW power substation connected to the national power grid and is currently providing power to the project.

*Concentrate Sales*

The Company has received competitive terms for the sale of silver and gold concentrates from an international concentrate trader and is in the process of closing an agreement for the 2011 estimated production.

*Caylloma Ag-Pb-Zn Mine*

Caylloma Mine Production	Quarters ended							
	30-Jun-11	31-Mar-11	31-Dec-10	30-Sep-10	30-Jun-10	31-Mar-10	31-Dec-09	30-Sep-09
<b>Tonnes milled</b>	<b>111,992</b>	104,937	112,257	112,886	108,010	101,503	97,989	105,241
<b>Average tons milled per day</b>	<b>1,273</b>	1,206	1,261	1,268	1,227	1,167	1,101	1,182
<b>Silver*</b>								
Grade (g/t)	<b>161.57</b>	157.56	159.51	154.56	156.35	167.23	164.26	146.54
Recovery %*	<b>81.65</b>	82.23	83.69	84.59	86.61	87.89	86.32	84.20
Production (Oz)*	<b>474,979</b>	437,123	481,802	474,489	470,310	479,821	446,970	417,571
<b>Lead</b>								
Grade (%)	<b>2.28</b>	2.36	2.37	2.27	2.30	2.87	3.14	2.95
Recovery %	<b>93.58</b>	92.40	90.93	91.07	90.71	92.19	93.29	93.23
Production (000's lb)	<b>5,275</b>	5,046	5,338	5,149	4,967	5,920	6,327	6,391
<b>Zinc</b>								
Grade (%)	<b>2.80</b>	2.87	2.87	3.10	3.02	3.44	3.43	3.58
Recovery %	<b>89.24</b>	86.56	86.77	87.90	88.03	89.17	89.18	88.58
Production (000's lb)	<b>6,177</b>	5,745	6,158	6,789	6,320	6,869	6,601	7,366
<b>Copper</b>								
Production (000's lb)	<b>0</b>	36	213	250	266	296	95	44
<b>Unit Costs</b>								
Production cash cost (US\$/oz ag)**	<b>(4.42)</b>	(5.36)	(6.58)	(3.13)	(3.83)	(9.84)	(10.67)	(5.38)
Production cash cost (US\$/tonne)	<b>63.29</b>	63.73	63.44	60.92	55.47	55.56	51.76	44.92
Unit Net Smelter Return (US\$/tonne)	<b>228.77</b>	207.99	185.96	146.97	144.91	174.01	172.79	120.41

\* Silver in lead and copper concentrates

\*\* Net of by-product credits

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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*Summary of Q2 2011 Mine Production Results:*

- Silver production of 474,979 ounces; 1% increase over Q2 2010;
- Lead production of 5,275 ('000's) pounds; 6% increase over Q2 2010;
- Zinc production of 6,177 ('000's) pounds; 2% decrease over Q2 2010; and,
- Cash cost per silver ounce, net of by-product credits, negative US\$4.42 (refer to Page 11).

Silver production at Caylloma for the first two quarters was 912,102 ounces with mill feed being sourced from the Animas, Bateas and Soledad veins. The increase in silver production for the quarter compared to the same period last year is mainly explained by higher silver head grades offset by lower metallurgical recovery rates. The latter is the result oxidized material coming from level 6 in Animas vein.

In January 2011, production of copper-silver concentrate was discontinued at Caylloma due to a material deterioration in treatment and refining smelter charges with respect to 2010. The Company is monitoring market conditions to evaluate restarting the circuit. Copper accounted for 4% of sales in 2010 (2009: 1%).

Cash cost per payable ounce of silver, for the second quarter ended June 30, 2011, was negative \$4.42 net of by-product credits compared to negative \$3.83 in 2010. The change was mainly attributable to an increase in revenue from by-product credits offset by higher refining charges and cash costs per tonne. See Page 11 for reconciliation of cash production cost to the cost of sales.

For the second quarter ended June 30, 2011, the cash cost per tonne of processed ore was \$63.29 (2010: \$55.47). Starting in the third quarter of 2010 our Peruvian operations have experienced increased cost pressures on labor, contractor tariffs, and industry related services. We expect these cost pressures to persist throughout 2011. Cash cost is a non-GAAP measure, see Page 11 for reconciliation of cash cost to the cost of sales.

The new high-grade silver ore shoots that were discovered through the extension of exploration and development drifts from current production areas on the 10<sup>th</sup> and 12<sup>th</sup> levels of the Bateas Vein (see press release of April 14, 2011) entered into production in late June. The exploration drift will continue to be advanced to the northeast to explore for additional high-grade ore shoots. Raises 308N and 310N have been completed between level 12 (4500m elevation) and level 10 (4620m elevation) confirming the vertical continuity of the high-grade shoots. Within the ore shoots, the vein ranges up to 2m in width.

Last month, the Company received the approval of the environmental impact study for the construction of a new tailings dam. The construction of the project involves two stages with: the first planned for conclusion in November 2011; the second one commencing in April 2012; and, planned for conclusion in November of the same year. The total tailings storage capacity corresponds to 7 years of mine life.

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

Caylloma Mine Concentrates	Quarters ended							
	30-Jun-11	31-Mar-11	31-Dec-10	30-Sep-10	30-Jun-10	31-Mar-10	31-Dec-09	30-Sep-09
<b>Zinc</b>								
Opening Inventory (t)	559	258	540	647	340	369	58	64
Production (t)	5,438	5,049	5,467	5,830	5,328	5,666	5,469	6,145
Sales (t)	5,213	4,757	5,749	5,950	5,013	5,707	5,163	6,156
Adjustment (t)	-14	9	0	13	-7	12	4	4
Closing Inventory (t)	771	559	258	540	647	340	369	58
Ag in concentrate (g/t)	113	108	105	100	93	85	95	104
Zn in concentrate (%)	51.52	51.61	51.09	52.83	53.81	54.99	54.75	54.37
<b>Lead</b>								
Opening Inventory (t)	515	191	404	525	249	408	75	5
Production (t)	4,244	3,864	3,829	3,626	3,361	4,199	4,490	4,799
Sales (t)	4,298	3,561	4,053	3,751	3,068	4,378	4,162	4,761
Adjustment (t)	9	21	10	4	-17	20	5	33
Closing Inventory (t)	471	515	191	404	525	249	408	75
Ag in concentrate (g/t)	3,481	3,189	1,685	1,490	1,491	1,344	2,365	2,462
Pb in concentrate (%)	56.38	59.23	63.23	64.40	67.04	63.94	63.94	60.43
<b>Copper</b>								
Opening Inventory (t)	4	29	44	66	57	46	10	2
Production (t)	0	80	448	496	522	619	207	93
Sales (t)	0	104	464	520	512	621	170	86
Adjustment (t)	0	-1	1	1	0	13	0	0
Closing Inventory (t)	4	4	29	44	66	57	46	10
Ag in concentrate (g/t)	0	15,876	19,056	18,866	18,433	14,982	15,640	12,723
Cu in concentrate (%)	0.00	20.23	21.62	22.87	23.16	21.66	20.72	21.84

*Financial Results*

During the second quarter ended June 30, 2011 the Company generated net income of \$6.20 million (2010: \$6.72 million) on operating income of \$10.67 million (2010: \$9.63 million). The decrease in net income compared to the previous year, in spite of higher sales of \$24.27 million (2010: \$14.42 million), is mainly explained by selling, general and administrative expenses of \$5.33 million (2010: \$nil), cost of sales of \$9.42 million (2010: \$7.51 million), a gain on commodity contracts of \$1.44 million (2010: gain \$2.90 million), and income taxes of \$4.56 million (2010: \$2.95 million).

During the six months ended June 30, 2011 the Company generated net income of \$10.98 million (2010: \$12.44 million) on operating income of \$18.74 million (2010: \$18.67 million). The decrease in net income compared to the prior year, in spite of higher sales of \$45.94 million (2010: \$31.80 million), is mainly explained by selling, general and administrative expenses of \$8.96 million (2010: \$1.99 million), a gain on commodity contracts of \$0.43 million (2010: gain \$4.64 million), and cost of sales of \$18.04 million (2010: \$15.43 million).

**FORTUNA SILVER MINES INC.****Management's Discussion and Analysis****For the second quarter ended June 30, 2011****(Dollar amounts expressed in US dollars, unless otherwise indicated)**

**Sales** for the second quarter ended June 30, 2011 increased by 68% to \$24.27 million (2010: \$14.42 million) compared to a year ago. Recorded sales were comprised of \$23.28 million of provisional sales plus \$2.03 million of mark-to-market (value of provisional sales is adjusted over time as final commodity prices are set in a period subsequent to the date of sale based on a specific quotational period, either one or three months after delivery at the option of the customer) minus \$1.04 million of final adjustments in Q2. The sales increase, compared to Q2 2010, is a mainly a result of higher realized prices for silver, lead, zinc of 112%, 24%, and 18%, respectively, and higher lead metal sold of 19%.

For the six months ended June 30, 2011, sales increased by 44% to \$45.94 million (2010: \$31.80 million), compared to last year. The increase is mainly a result of higher realized prices for silver, lead, and zinc of 100%, 18%, and 12%, respectively, in spite of lower metal sold for silver, lead and zinc of 4%, 6% and 12% respectively.

**Caylloma Mine Metal Sold and Prices**

	Quarters ended							
	30-Jun-11	31-Mar-11	31-Dec-10	30-Sep-10	30-Jun-10	31-Mar-10	31-Dec-09	30-Sep-09
<b>Silver</b>								
Sales (Oz)*	455,777	423,236	494,451	487,408	441,767	471,077	413,607	413,445
Realized Price (US\$/Oz)**	36.87	29.89	25.08	17.89	17.36	16.19	16.69	13.81
Weighted Average Price (US\$/Oz)***	38.07	31.08	25.96	18.78	18.24	17.05	17.59	14.72
<b>Lead</b>								
Sales (000's lb)*	5,368	4,637	5,605	5,261	4,494	6,101	5,757	6,215
Realized Price (US\$/lb)**	0.98	0.99	0.92	0.77	0.79	0.87	0.88	0.64
Weighted Average Price (US\$/lb)***	1.17	1.18	1.07	0.90	0.92	1.01	1.04	0.88
<b>Zinc</b>								
Sales (000's lb)*	5,914	5,445	6,487	6,927	5,923	6,968	6,245	7,318
Realized Price (US\$/lb)**	0.80	0.85	0.76	0.64	0.68	0.78	0.64	0.50
Weighted Average Price (US\$/lb)***	1.03	1.09	1.04	0.90	0.94	1.04	1.00	0.80
<b>Copper</b>								
Sales (000's lb)*	-	52	221	260	252	289	75	38
Realized Price (US\$/lb)**	-	2.81	3.25	2.69	2.59	2.57	2.16	1.88
Weighted Average Price (US\$/lb)***	-	4.23	3.88	3.24	3.22	3.30	3.17	2.80
<b>Gold</b>								
Sales (Oz)*	637	635	696	597	517	600	914	294
Realized Price (US\$/Oz)**	1,483.09	1,369.75	1,356.31	1,219.42	1,184.10	1,104.98	1,097.03	955.71
Weighted Average Price (US\$/Oz)***	1,493.09	1,379.19	1,362.56	1,225.50	1,190.10	1,111.42	1,105.72	965.34

\* The current and subsequent period may include final settlement quantity adjustments from prior periods.

\*\* Considers deductions, treatment, and refining charges as applicable. Treatment charges are allocated to the base metals.

Realized prices are based on provisional sales and are calculated before governmental royalties.

\*\*\* Average price for the quarter weighted by monthly metal volume in provisional sales.

**Cost of sales**, for the second quarter ended June 30, 2011, increased by 26% to \$9.42 million (2010: \$7.51 million) compared to last year. The increase is primarily attributable to a 14% higher unit production cash costs and increased throughput of 4%. Refer to Page 7 discussion on cash cost per tonne of treated ore.

**FORTUNA SILVER MINES INC.****Management's Discussion and Analysis****For the second quarter ended June 30, 2011****(Dollar amounts expressed in US dollars, unless otherwise indicated)**

For the for the six months ended June 30, 2011, cost of sales increased by 17% to \$18.04 million (2010: \$15.43 million) compared to last year. The increase is primarily attributable to a 14% higher unit production cash costs and increased throughput of 4%.

**Selling, general and administrative expenses** increased by 100%, for the second quarter ended June 30, 2011, to \$5.33 million (2010: \$nil). The increase is primarily attributable to share-based payments of \$1.93 million in 2011 compared to a recovery of \$2.44 million in 2010.

For the six months ended June 30, 2011, selling, general and administrative expenses increased by 350% to \$8.96 million (2010: \$1.99 million). The increase is primarily attributable to share-based payments of \$2.38 million in 2011 compared to a recovery of \$2.44 million in 2010.

	<b>Expressed in \$ millions</b>			
	<b>Three months ended June 30, 2011</b>		<b>Six months ended June 30, 2010</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Corporate general and administrative expenses	\$ <b>2.40</b>	\$ 1.87	\$ <b>4.54</b>	\$ 3.16
Foreign exchange	<b>(0.04)</b>	(0.12)	<b>0.12</b>	(0.02)
Share-based payments	<b>1.93</b>	(2.44)	<b>2.38</b>	(2.44)
Peruvian subsidiary	<b>0.87</b>	0.69	<b>1.60</b>	1.29
Workers' participation	<b>0.17</b>	-	<b>0.32</b>	-
	<b>\$ 5.33</b>	\$ -	<b>\$ 8.96</b>	\$ 1.99

**Exploration and evaluation costs**, for the second quarter of June 30, 2011, increased to \$0.32 million (2010: \$0.17 million) as the Company pursues its exploration program.

**Net gain on commodity contract**, for the second quarter ended June 30, 2011, was \$1.44 million (2010: gain \$2.90 million). The gain is related to short term contracts used to fix the final settlement price on metal contained in concentrate delivered throughout the period and explained by the rise in silver and base metal prices between April and June 2011. The Company does not use hedge accounting.

**Interest income**, for the second quarter ended June 30, 2011, increased by 109% to \$0.23 million (2010: \$0.11 million). The increase in interest income is primarily attributable to higher interest rates applied to higher cash and cash equivalents.

**Interest expense**, for the second quarter ended June 30, 2011, increased by 93% to \$0.14 million (2010: \$0.07 million) compared to a year ago. The increase is primarily attributable to credit facility fees with the Bank of Nova Scotia.

**Income taxes**, for the second quarter ended June 30, 2011, increased by 55% to \$4.56 million (2010: \$2.95 million) due to higher income recorded at Bateas. Income tax provision is comprised of \$4.27 million of current and \$0.29 million of deferred income tax expense mainly related to our Peruvian operations.

**FORTUNA SILVER MINES INC.****Management's Discussion and Analysis****For the second quarter ended June 30, 2011****(Dollar amounts expressed in US dollars, unless otherwise indicated)**

**Income taxes**, for the six months ended June 30, 2011, increased by 27% to \$7.97 million (2010: \$6.26 million) due to higher income recorded at Bateas compared to the prior year.

**Cash cost per silver ounce and cash cost per tonne (non-GAAP measures)**

Cash cost per ounce and cash cost per tonne are key performance measures that management uses to monitor performance. In addition, cash costs are presented as they represent an industry standard method of comparing certain costs on a per unit basis. Management believes that certain investors use these non-GAAP measures to evaluate the Company's performance. These performance measures have no meaning under International Financial Reporting Standards ("IFRS") and, therefore, amounts presented may not be comparable to similar data presented by other mining companies.

The following table presents a reconciliation of cash costs per tonne of processed ore and cash cost per ounce of payable silver to the cost of sales in the condensed Consolidated Statements of Income for the three and six months ended June 30, 2011 and 2010.

<b>Caylloma Mine Cash Cost</b>	<b>Expressed in \$'000's</b>		<b>Expressed in \$'000's</b>	
	<b>Q2 2011</b>	<b>YTD Q2 2011</b>	<b>Q2 2010</b>	<b>YTD Q2 2010</b>
<b>Cost of sales</b> <sup>2, 3</sup>	9,422	18,042	7,507	15,427
<b>Add / (Subtract)</b>				
<b>Change in concentrate inventory</b>	(4)	559	353	146
<b>Inventory adjustment</b>	-	-	-	-
<b>Workers participation</b>	(852)	(1,573)	(389)	(980)
<b>Depletion and depreciation</b> <sup>2</sup>	(1,478)	(3,252)	(1,480)	(2,963)
<b>Cash cost</b>	7,088	13,776	5,991	11,630
<b>Total processed ore (tonnes)</b>	111,992	216,929	108,010	209,513
<b>Cash cost per tonne of processed ore (\$/t)</b>	63.29	63.50	55.47	55.51
<b>Cash cost</b>	7,088	13,776	5,991	11,630
<b>Add / (Subtract)</b>				
<b>By-product credits</b> <sup>1</sup>	(9,624)	(19,047)	(8,090)	(18,609)
<b>Refining charges</b>	541	1,051	386	781
<b>Cash cost applicable per payable ounce</b>	(1,995)	(4,220)	(1,713)	(6,198)
<b>Payable silver ounces</b>	451,230	866,497	446,795	902,625
<b>Cash cost per ounce of payable silver (\$/oz)</b>	(4.42)	(4.87)	(3.83)	(6.87)

<sup>1</sup> By-product credits as included in the provisional liquidation

<sup>2</sup> 2010 and 2011 figures in accordance with IFRS

<sup>3</sup> includes depletion, depreciation, distribution, community relations, and workers participation

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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**Liquidity and Capital Resources**

The Company's cash and cash equivalents as at June 30, 2011 totalled \$63.78 million, and short term investments totalled \$10.76 million. Working capital amounted to \$76.56 million.

During the second quarter ended June 30, 2011, cash generated by operating activities before changes in working capital, income taxes, and interest income (a non-GAAP measure) was \$12.22 million (2010: \$6.97 million). Changes in working capital amounted to \$3.28 million (2010: \$0.39 million), and income tax and interest income amounted to \$4.47 million (2010: \$2.91 million), resulting in cash generated by operating activities of \$11.03 million (2010: \$4.45 million).

During the six months ended June 30, 2011, cash generated by operating activities before changes in working capital, income taxes, and interest income (a non-GAAP measure) was \$23.24 million (2010: \$15.77 million). Changes in working capital amounted to \$4.37 million (2010: \$0.59 million), and income tax and interest income amounted to \$7.76 million (2010: \$6.22 million), resulting in cash generated by operating activities of \$19.85 million (2010: \$8.96 million).

Cash generated by operating activities before changes in working capital, income taxes, and interest income (a non-GAAP measure) is calculated as follows (expressed in '000's):

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2011</b>	2010	<b>2011</b>	2010
<b>OPERATING ACTIVITIES</b>				
Net income before income taxes and interest	\$ 10,665	\$ 9,629	\$ 18,742	\$ 18,667
Items not involving cash				
Depletion and depreciation	1,504	1,492	3,327	2,990
Discount unwinding	42	41	81	80
Deferred income tax	287	1,515	308	2,652
Share-based payments	1,553	(2,440)	2,004	(2,440)
Unrealized (gain) on commodity contracts	(1,799)	(3,306)	(1,186)	(6,318)
(Gain) loss on disposal of mineral properties, property, plant and equipment	(31)	4	(53)	107
Accrued interest on loans receivable and payable	(3)	33	12	29
	<b>12,218</b>	6,968	<b>23,235</b>	15,767

Cash consumed by the Company, for the second quarter ended June 30, 2011, in investing activities totalled \$8.52 million (2010: \$22.51 million) with \$21.79 million (2010: \$6.85 million) for mineral properties, property, plant and equipment, \$2.17 million (2010: \$0.02 million) for net receipts on deposits on long term assets, \$10.23 million net redemptions (2010: purchases \$15.17 million) of short term investments, and payments of VAT of \$0.87 million (2010: receipts \$0.51 million).

Cash consumed by the Company, for the six months ended June 30, 2011, in investing activities totalled \$27.65 million (2010: \$21.91 million) with \$34.12 million (2010: \$11.21 million) for mineral properties, property, plant and equipment, \$3.37 million (2010: \$nil) for net advances on deposits on long term assets, \$10.23 million net redemptions (2010: purchases \$10.14 million) of short term investments, receipts of VAT of \$0.40 million (2010: receipts \$0.57 million), and proceeds on disposal of mineral properties, property, plant, and equipment of \$nil (2010: \$0.01 million). The total investment in San Jose amounted to \$34.40 million and included \$30.84 million for mineral properties, property, plant and equipment, and \$3.56 million for deposits on long term assets.

**FORTUNA SILVER MINES INC.****Management's Discussion and Analysis****For the second quarter ended June 30, 2011****(Dollar amounts expressed in US dollars, unless otherwise indicated)**

During the second quarter ended June 30, 2011, cash consumed in financing activities totalled \$0.18 million (2010: \$0.16 million) includes the repayment of long term debt of \$0.02 million (2010: \$nil), repayment of finance lease obligations of \$0.29 million (2010: \$0.29 million), offset by cash provided by net proceeds on the issuance of common shares of \$0.13 million (2010: \$0.13 million).

During the six months ended June 30, 2011, cash consumed in financing activities totalled \$0.10 million (2010: provided \$40.00 million), repayment of finance lease obligations of \$0.56 million (2010: \$0.55 million), offset by cash provided by net proceeds on the issuance of common shares of \$0.46 million (2010: \$31.55 million).

In 2010, the Company entered into a credit agreement with the Bank of Nova Scotia for a \$20 million senior secured revolving credit facility ("credit facility") to be refinanced or repaid on or within two and one-half years or before December 2012. The credit facility is secured by a first ranking lien on Bateas and its assets and bears interest and fees at prevailing market rates. No funds were drawn from this credit facility during the period.

The Company has raised funds from two prospectus financings. The details of the expected use of proceeds and actual use of proceeds are discussed below.

**Prospectus February 18, 2010 Closed March 2, 2010**

	<b>San Jose Project Financing</b>			
	<b>Expressed in CAD \$ millions</b>			
	Actual Use			
Expected Use of Proceeds*	of Proceeds**	Variance		
Mine development	\$ 6.7	\$ 6.4	\$ 0.3	
Processing plant	16.6	20.5	(3.9)	
Tailings dam	1.9	4.3	(2.4)	
Water and Infrastructure	3.0	2.9	0.1	
Energy supply	-	2.5	(2.5)	
Construction management	-	1.9	(1.9)	
<b>Total</b>	<b>\$ 28.2</b>	<b>\$ 38.5</b>	<b>\$ (10.3)</b>	

\*excludes over-allotment

\*\*US CAD FX rate at 1.0

**Prospectus December 17, 2010 Closed December 23, 2010**

	<b>San Jose Project Financing**</b>			
	<b>Expressed in CAD \$ millions</b>			
	Expected			
Use of Proceeds*	Actual Use of Proceeds	Variance		
Planned expansion	\$ 14.5	\$ -	\$ 14.5	
Exploration programs	5.5	-	5.5	
Working capital	17.7	-	17.7	
<b>Total</b>	<b>\$ 37.7</b>	<b>\$ -</b>	<b>\$ 37.7</b>	

\*excludes over-allotment

\*\* funds to be utilized post development

Management believes the Company's cash position, along with its ongoing operation in Caylloma and the credit facility, 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 it recognizes the uncertainty attached thereto.

*Guarantees and Indemnifications (expressed in \$'000's)*

The Company may provide guarantees and indemnifications in conjunction with transactions in the normal course of operations. These are recorded as liabilities when reasonable estimates of the obligations can be made. Indemnifications that the Company has provided include obligation to indemnify:



## **FORTUNA SILVER MINES INC.**

### **Management's Discussion and Analysis**

**For the second quarter ended June 30, 2011**

**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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- directors and officers of the Company and its subsidiaries for potential liability while acting as a director or officer of the Company, together with various expenses associated with defending and settling such suits or actions due to association with the Company;
- certain vendors of acquired company for obligations that may or may not have been known at the date of the transaction.

The Caylloma mine closure plan was approved in November 2009 with total closure costs of \$3,587 of which \$1,756 is subject to annual collateral in the form of a letter of guarantee, to be awarded each year in increments of \$146 over 12 years based on the estimated life of the mine.

Banco Bilbao Vizcaya Argentaria, S.A., a third party, has established a bank letter of guarantee on behalf of Bateas in favor of the Peruvian mining regulatory agency in compliance with local regulation associated with the approved Bateas' mine closure plan, for the sum of \$293. This bank letter of guarantee expires 360 days from December 2010.

Banco Bilbao Vizcaya Argentaria, S.A., has also established bank letters of guarantee totalling \$54 to provide an annual guarantee associated with an office lease contract and truck rentals. These bank letters of guarantee were renewed in June 2011 with expiry 360 days to June 2012.

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

The Company does not have any off-balance sheet arrangements or commitments that are expected to have a current or future effect on our financial condition, results of operations, liquidity, capital expenditures, or capital resources that is material to investors, other than those disclosed in this MD&A and the consolidated financial statements and the related notes, other than operating leases.

### **Related Party Transactions**

Refer to Note 9 to the condensed interim consolidated financial statements for related party transactions.

The transactions with related parties are measured at the agreed upon exchange amount, which is the amount of consideration established and agreed upon by the parties. The balances with related parties are unsecured, non-interest bearing, and payable in the normal course of business.

### **Significant Accounting Judgments and Estimates**

The preparation of these condensed consolidated financial statements requires management to make judgments and estimates that affect the reported amounts of assets and liabilities at the date of the financial statements and reported amounts of expenses during the reporting period. Actual outcomes could differ from these judgments and estimates. The condensed consolidated financial statements include judgments and estimates which, by their nature, are uncertain. The impacts of such judgments and estimates are pervasive throughout the condensed consolidated financial statements, and may require accounting adjustments based on future occurrences. Revisions to accounting estimates are recognized in the period in which the estimate is revised and the revision affects both current and future periods. Significant assumptions about the future and other sources of judgments and estimates that management has made at the statement of financial position date, that could result in a material adjustment to the carrying amounts of assets and liabilities, in the event that actual results differ from assumptions made, relate to, but are not limited to, the following:

## **FORTUNA SILVER MINES INC.**

### **Management's Discussion and Analysis**

**For the second quarter ended June 30, 2011**

**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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#### *i. Critical Judgments*

- The analysis of the functional currency for each entity of the Company. In concluding that the United States dollar ("US\$), with the exception of the parent entity and certain holding companies which have a Canadian dollar ("CAD\$") functional currency, management considered the currency that mainly influences the cost of providing goods and services in each jurisdiction in which the Company operates. As no single currency was clearly dominant the Company also considered secondary indicators including the currency in which funds from financing activities are denominated and the currency in which funds are retained.

#### *ii. Estimates*

- The recoverability of amounts receivable which are included in the consolidated statements of financial position;
- the estimation of assay grades of metal concentrates sold in the determination of the carrying value of accounts receivable which are included in the consolidated statements of financial position and included as sales in the consolidated statements of income;
- the carrying value of the short term investments and the recoverability of the carrying value which are included in the consolidated statements of financial position;
- the determination of net realizable value of inventories on the consolidated statements of financial position;
- the estimated useful lives of property, plant and equipment which are included in the consolidated statements of financial position and the related depreciation included in the consolidated statements of income;
- the determination of mineral reserve, carrying amount of mineral properties, and depletion of mineral properties included in the consolidated statements of financial position and the related depletion included in the consolidated statements of income;
- the determination of the fair value of financial instruments and derivatives included in the consolidated statements of financial position;
- the fair value estimation of share-based awards included in the consolidated statements of financial position and the inputs used in accounting for share-based compensation expense in the consolidated statements of income;
- the provision for income taxes which is included in the consolidation statements of income and composition of deferred income tax asset and liabilities included in the consolidated statement of financial position;
- the inputs used in determining the net present value of the liability for provisions related to decommissioning and restoration included in the consolidated statements of financial position;
- the inputs used in determining the various commitments and contingencies accrued in the consolidated statements of financial position; and,
- the assessment of indications of impairment of each mineral properties and related determination of the net realizable value and write-down of those properties where applicable.

#### Financial Instruments and Related Risks

The Company's financial instruments are exposed to certain financial risks, including currency risk, credit risk, liquidity risk, interest risk, and price risk. The Company's Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework and reviews the Company's policies on an ongoing basis. Refer to Note 15 to the condensed interim consolidated financial statements and the Company's Annual Information Form filed on Sedar.

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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**Other Data**

Additional information related to the Company is available for viewing at [www.sedar.com](http://www.sedar.com) and the Company's website at [www.fortunasilver.com](http://www.fortunasilver.com).

**Share Position and Outstanding Warrants and Options**

The Company's outstanding share position as at August 10, 2011 is 123,349,221 common shares. In addition, a total of 5,497,789 incentive stock options are currently outstanding as follows:

<u>Type of Security</u>	<u>No. of Shares</u>	<u>Exercise Price (CAD\$)</u>	<u>Expiry Date</u>
Incentive Stock Options:	240,000	\$1.35	February 5, 2016
	200,000	\$2.29	March 30, 2016
	60,000	\$1.75	May 8, 2016
	200,000	\$1.75	May 22, 2016
	2,500	\$0.85	July 5, 2016
	225,000	\$1.55	July 5, 2016
	600,000	\$1.66	July 10, 2016
	225,000	\$1.61	September 13, 2016
	60,000	\$0.85	January 11, 2017
	670,000	\$2.22	January 11, 2017
	38,000	\$0.85	June 27, 2017
	25,000	\$0.85	October 24, 2017
	250,000	\$2.52	February 5, 2018
	470,000	\$0.85	October 5, 2018
	240,000	\$0.85	November 5, 2018
	200,000	\$0.83	July 6, 2019
	1,792,289	\$4.46	June 8, 2014
<b>TOTAL OUTSTANDING OPTIONS</b>	<b><u>5,497,789</u></b>		

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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**International Financial Reporting Standards ("IFRS")**

Effective January 1, 2011, Canadian publicly listed entities were required to prepare their financial statements in accordance with IFRS. Due to the requirement to present comparative financial information, the effective transition date is January 1, 2010.

Our IFRS conversion team identified three phases to our conversion: Scoping and Diagnostics, Analysis and Development, and Implementation and Review.

We have now completed our IFRS conversion project through implementation. Review and post-implementation will continue in future periods, as outlined below.

The following outlines our transition project, IFRS transitional impacts and the on-going impact of IFRS on our financial results.

**Transitional Financial Impact**

**Equity Impact**

As a result of the policy choices we have selected and the changes we were required to make under IFRS, we have recorded a reduction in our equity of approximately \$0.47 million as at June 30, 2010. The table below outlines adjustments to our equity on adoption of IFRS on June 30, 2010, and December 31, 2010 for comparative purposes.

<b><u>Expressed in \$ millions</u></b>	<b><u>Notes</u></b>	<b><u>June 30, 2010</u></b>	<b><u>December 31, 2010</u></b>
Shareholders' Equity, Canadian GAAP		\$ 153.34	\$ 206.01
Adjustments:			
Effect of foreign exchange on inventory, deposits on long term assets, and mineral properties, property, plant and equipment	19 a)	(2.38)	(5.34)
Deferred income tax adjustments	19 b)	2.01	1.94
Transfer of accumulated other comprehensive income to retained earnings (deficit)	19 c)	2.90	2.90
Reset accumulated other comprehensive income to zero	19 c)	(2.90)	(2.90)
Adjustment to revise provisions	19 d)	(0.30)	(0.25)
Adjustment for depletion on mineral properties related to provisions	19 d)	0.20	0.23
<b>Total IFRS adjustments to Equity</b>		<b>(0.47)</b>	<b>(3.42)</b>
<b>Equity, IFRS</b>		<b>\$ 152.87</b>	<b>\$ 202.59</b>

Note: There may be differences due to rounding of decimal places

A reconciliation of our comprehensive income under Canadian GAAP and IFRS for the three and six months ended June 30, 2010 and a discussion of the impact of IFRS on our cash flows are provided below.

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

**Comprehensive Income Impact**

As a result of the policy choices we have selected and the changes we were required to make under IFRS, we have also recorded an increase in our net income of approximately \$0.7 million and \$1.2 million for the three and six months ended June 30, 2010, respectively. We have recorded an increase in our total comprehensive income of approximately \$1.8 million and \$0.7 million for the three and six months ended June 30, 2010, respectively.

The following is a summary of the adjustments to comprehensive income for the three and six months ended June 30, 2010 under IFRS (all of which are outlined in the notes to our condensed interim consolidated financial statements):

expressed in \$ millions	Notes	Three months ended June 30, 2010			Six months ended June 30, 2010		
		CAD GAAP	Effect of Transition to IFRS	IFRS	CAD GAAP	Effect of Transition to IFRS	IFRS
Income for the period		\$ 6.0	\$ 0.7	\$ 6.7	\$ 11.3	\$ 1.2	\$ 12.5
Other comprehensive income (loss)							
Transfer of unrealized loss to realized loss upon reduction of net investment, net of taxes	19 c)	0.6	(0.6)	-	0.6	(0.6)	-
Unrealized gain on translation of functional currency to reporting currency	19 a)	(2.9)	1.7	(1.2)	(0.2)	0.1	(0.1)
Other comprehensive (loss) income		\$ (2.4)	\$ 1.1	\$ (1.3)	0.4	(0.4)	-
Total comprehensive income for the period		\$ 3.6	\$ 1.8	\$ 5.4	\$ 11.7	\$ 0.7	\$ 12.4

Note: There may be differences due to rounding of decimal places

**Cash Flow Impact**

The adoption of IFRS has had no material impact on the net cash flows of the Company. The changes made to the Consolidated Statements of Financial Position and Consolidated Statements of Comprehensive Income has resulted in reclassifications of various amounts on the Consolidated Statements of Cash Flows, however there is no net impact on cash and cash equivalents.

**Financial Statement Presentation Changes**

The transition to IFRS has resulted in financial statement presentation changes in our financial statements, most significantly on the consolidated statement of income. The changes to the balance sheet relate mainly to the combining of mineral properties, property, plant and equipment and renaming of asset retirement obligations to provisions; future income tax liability to deferred income tax liabilities; and contributed surplus to share option and warrant reserve.

The following is a summary of the significant changes to our consolidated statement of income:

- expenses by function and nature – our statement of income presents expenses by function. Accordingly, depreciation, depletion, and accretion are no longer presented as a separate line item on the statement of

## **FORTUNA SILVER MINES INC.**

### **Management's Discussion and Analysis**

**For the second quarter ended June 30, 2011**

**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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income but depreciation and depletion are included in cost of sales. Unwinding of discount is included in interest expense;

- government royalties to sales from selling, general and administrative expenses;
- distribution costs to cost of sales from selling, general and administrative expenses;
- community relation costs to cost of sales from selling, general and administrative expenses;
- other income and expenses from interest and other income and expenses to selling, general and administrative expenses;
- exploration and evaluation costs moved from selling, general and administrative expenses;
- interest expense includes interest on debt financing and unwinding of discount; and,
- current workers participation from income tax to cost of sales and selling, general and administrative expenses.

The above changes are reclassifications within our statement of income so there is no net impact to our income as a result of these changes.

#### **Control Activities**

For all changes to policies and procedures that have been identified, the effectiveness of internal controls over financial reporting and disclosure controls and procedures has been assessed and any changes have been implemented. In addition, controls over the IFRS changeover process have been implemented, as necessary. We have identified and implemented the required accounting process changes that resulted from the application of IFRS accounting policies and these changes were not significant. We have completed the design, implementation and documentation of the internal controls over accounting process changes resulting from the application of IFRS accounting policies. We applied our existing control framework to the IFRS changeover process. All accounting policy changes and transitional financial position impacts were subject to review by senior management and the Audit Committee of the Board of Directors.

#### **Business Activities and Key Performance Measures**

We have assessed the impact of the IFRS transition project on our financial covenants and key ratios. The transition did not significantly impact our covenants and key ratios that have an equity component.

We have also reviewed the impact of the IFRS transition project on our compensation arrangements. We have identified compensation arrangements that are calculated based on indicators in our financial statements. We are continuing to work with our Human Resources department to ensure that all compensation arrangements incorporate indicators from our financial statements prepared under IFRS in accordance with our compensation policies.

#### **Information Technology and Systems**

The IFRS transition project did not have a significant impact on our information systems for the convergence periods. We also do not expect significant changes in the post-convergence periods.

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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**Review**

The post-implementation phase will involve continuous monitoring of changes in IFRS in future periods. We note that the standard-setting bodies that determine IFRS have significant ongoing projects that could impact the IFRS accounting policies that we have selected. In particular, we expect that there may be additional new or revised IFRSs or IFRICs in relation to consolidation, joint ventures, financial instruments, hedge accounting, discontinued operations, leases, employee benefits, revenue recognition and stripping costs in the production phase of a surface mine. We also note that the International Accounting Standards Board is currently working on an extractive industries project, which could significantly impact our financial statements primarily in the areas of capitalization of exploration costs and disclosures. We have processes in place to ensure that potential changes are monitored and evaluated. The impact of any new IFRSs and IFRIC Interpretations will be evaluated as they are drafted and published.

**Other Risks and Uncertainties**

There have been no major changes from the reported risks factors outlined in the Annual Information Form dated March 24, 2011.

**Controls and Procedures**

*Disclosure Controls and Procedures*

The Company evaluated the effectiveness of the design and operation of the disclosure controls and procedures, as of June 30, 2011, 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.

*Internal Control over Financial Reporting*

The Company's management, with the participation of its CEO and CFO, are 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.

The Company's management, including its CEO and CFO, believe that due to its inherent limitations, internal control over financial reporting may not prevent or detect misstatements on a timely basis. Also, projection of any evaluation of the effectiveness of internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

There has been no change in the Company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, its internal control over financial reporting.

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

**Outlook**

The updated outlook is based on the mineral reserves reported in the Company's release dated April 12, 2011.

***2011 - 2019 San Jose Mine Plan (refer to release dated June 1, 2011)***

The increase of the start-up production rate from 750 tpd to 1,000 tpd at San Jose has been made possible by recent underground development accessing approximately 255,000 tonnes of resources above level 1400, the first production level. The updated mine plan allows for an increase in the production and treatment rate to 1,500 tpd by the third quarter of 2013, two and a half years ahead of the prefeasibility study released in April 2010.

**San Jose Mine's Production Schedule Breakdown**

	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total
<b>Tonnes (milled)</b>	120,000	360,000	422,300	540,000	540,000	540,000	540,000	540,000	168,719	3,771,019
<b>Ag grade (g/t)</b>	153	169	185	196	204	211	233	215	196	202
<b>Au grade (g/t)</b>	1.32	1.47	1.51	1.47	1.51	1.57	1.79	1.76	1.59	1.58
<b>Ag recovery (%)</b>	88	88	88	88	88	88	88	88	88	88
<b>Au recovery (%)</b>	90	90	90	90	90	90	90	90	90	90
<b>Ag production (oz)</b>	520,613	1,726,134	2,206,967	2,993,336	3,120,446	3,228,191	3,553,770	3,286,027	933,358	21,568,842
<b>Au production (oz)</b>	4,584	15,326	18,429	23,004	23,607	24,579	27,987	27,527	7,771	172,815

**San Jose Mine Projected Operating Cost and Life of Mine Capital Expenditure**

	2011	2012	2013	2014	2015	2016	2017	2018	2019
<b>Total Cash Cost per Tonne (US\$/t)</b>	51	50	45	43	44	43	43	43	56
<b>CAPEX (US\$M)</b>	5.7	13.4	21.4	13.1	8.4	6.9	7.0	5.9	5.8

***Consolidated Production Forecast for the Period 2011 - 2015 (refer to release dated June 1, 2011)***

	2011	2012	2013	2014	2015
<b>Silver (million oz)</b>	2.4	3.7	4.1	4.9	4.9
<b>Gold (oz)</b>	7,368	18,041	21,143	25,948	27,083
<b>Zinc (lbs)</b>	22,387,109	23,227,528	21,934,455	22,559,726	19,745,217
<b>Lead (lbs)</b>	16,011,069	16,615,757	15,863,412	16,152,207	14,196,226



## **FORTUNA SILVER MINES INC.**

### **Management's Discussion and Analysis**

**For the second quarter ended June 30, 2011**

**(Dollar amounts expressed in US dollars, unless otherwise indicated)**

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#### **Cautionary Statement on Forward-Looking Information**

Certain statements contained in this MD&A and any documents incorporated by reference into this MD&A constitute forward-looking statements and forward-looking information. Any statements or information that express or involve discussions with respect to predictions, expectations, beliefs, plans, projections, objectives, assumptions or future events or performance (often, but not always, using words or phrases such as "expects", "is expected", "anticipates", "believes", "plans", "projects", "estimates", "assumes", "intends", "strategies", "targets", "goals", "forecasts", "objectives", "budgets", "schedules", "potential" or variations thereof or stating that certain actions, events or results "may", "could", "would", "might" or "will" be taken, occur or be achieved, or the negative of any of these terms and similar expressions) are not statements of historical fact and may be forward-looking statements or information. Forward-looking statements or information relate to, among other things:

- estimates of mineral reserves and mineral resources to the extent that they involve estimates of the mineralization that will be encountered if the property is developed;
- timing of the completion of construction activities at the Company's properties and their completion on budget;
- production rates at the Company's properties;
- cash cost estimates;
- timing to achieve full production capacity at the Company's properties;
- timing for completion of infrastructure upgrades related to the Company's properties;
- timing for delivery of materials and equipment for the Company's properties; and
- the sufficiency of the Company's cash position and its ability to raise equity capital or access debt facilities.

Forward-looking statements are necessarily based upon a number of estimates and assumptions that, while considered reasonable by the Company as at the date of such statements, are inherently subject to significant business, economic, social, political and competitive uncertainties and contingencies and other factors that could cause actual results or events to differ materially from those projected in the forward-looking statements. The estimates and assumptions of the Company contained or incorporated by reference in this MD&A which may prove to be incorrect, include, but are not limited to, (1) that all required third party contractual, regulatory and governmental approvals to the Offer will be obtained for the development, construction and production of its properties, (2) there being no significant disruptions affecting operations, whether due to labour disruptions, supply disruptions, power disruptions, damage to equipment or otherwise; (3) permitting, development, expansion and power supply proceeding on a basis consistent with the Company's current expectations; (4) currency exchange rates being approximately consistent with current levels; (5) certain price assumptions for silver, lead, zinc and copper; (6) prices for and availability of natural gas, fuel oil, electricity, parts and equipment and other key supplies remaining consistent with current levels; (7) production forecasts meeting expectations; (8) the accuracy of the Company's current mineral resource and reserve estimates; (9) labour and materials costs increasing on a basis consistent with the Company's current expectations; and (10) assumptions made and judgments used in engineering and geological interpretation.

In addition, there are known and unknown risk factors which could cause the Company's actual results, performance or achievements to differ materially from any future results, performance or achievements expressed or implied by the forward-looking statements. Known risk factors include, risks associated with project development; the need for additional financing; operational risks associated with mining and mineral

**FORTUNA SILVER MINES INC.**  
**Management's Discussion and Analysis**  
**For the second quarter ended June 30, 2011**  
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processing; changes in national and local government legislation, taxation, controls, regulations and political or economic developments in Canada, Mexico, the United States, Peru or other countries in which the Company does or may carry on business; the possibility of cost overruns or unanticipated expenses; fluctuations in silver, lead, zinc and copper prices; title matters; uncertainties and risks related to carrying on business in foreign countries; environmental liability claims and insurance; reliance on key personnel; currency exchange rate fluctuations; competition; and other risks and uncertainties, including those described in the Risks and Uncertainties section in the MD&A and in the Risk Factors section in the Company's Annual Information Form for the financial year ended December 31, 2010 filed with the Canadian Securities Administrators and available at [www.sedar.com](http://www.sedar.com).

Although the Company has attempted to identify important factors that could cause actual actions, events or results to differ materially from those described in forward-looking statements, there may be other factors that cause actions, events or results not to be as anticipated, estimated or intended. These forward-looking statements are made as of the date of this MD&A. There can be no assurance that forward looking statements will prove to be accurate, as actual results and future events could differ materially from those anticipated in such statements. Accordingly, readers should not place undue reliance on forward-looking statements. Except as required by law, the Company does not assume the obligation to revise or update these forward looking statements after the date of this document or to revise them to reflect the occurrence of future unanticipated events.