Interim Unaudited Financial Statements

Karnalyte
RESOURCES

Three and six months ended June 30, 2014

KARNALYTE RESOURCES INC.

STATEMENTS OF FINANCIAL POSITION

ASSETS

(CAD thousands, unaudited)	**June 30, 2014**	**December 31, 2013**
Current assets		
Cash	$ 44,409	$ 46,161
Trade and other receivables	329	1,480
Prepaid expenses	89	139
	44,827	47,780
Restricted cash	375	375
Deferred financing costs	1,672	1,606
Capital assets (note 4)	19,226	18,745
Intangible exploration and evaluation and other assets (note 5)	43,009	42,951
ASSETS	$ 109,109	$ 111,457
LIABILITIES		
Current liabilities		
Trade and other payables	$ 615	$ 746
	615	746
Provisions	148	135
Total liabilities	763	881
SHAREHOLDERS' EQUITY		
Share capital (note 6(a))	129,780	129,774
Contributed surplus	8,143	7,778
Deficit	(29,577)	(26,976)
Total shareholders' equity	108,346	110,576
LIABILITIES AND SHAREHOLDERS' EQUITY	$ 109,109	$ 111,457

Commitments (note 9)

See accompanying notes to the unaudited interim financial statements.

KARNALYTE RESOURCES INC.

STATEMENTS OF COMPREHENSIVE LOSS

For the three and six months ended June 30,

(CAD thousands except per share amounts, unaudited)	Three months ended 2014	Three months ended 2013	Six months ended 2014	Six months ended 2013
Expenses				
General and administrative	$ 1,459	$ 1,304	$ 2,403	$ 2,386
Depreciation and amortization	192	197	409	404
Share-based compensation expense (note 7)	(128)	684	184	1,109
Other (income) and expenses	(14)	9	(45)	(4)
	1,509	2,194	2,951	3,895
Finance income	(168)	(521)	(360)	(598)
Finance expense	6	2	10	29
Net finance income	(162)	(519)	(350)	(569)
Comprehensive loss	(1,347)	(1,675)	(2,601)	(3,326)
Loss per share (note 6(b))				
Basic and diluted	$ (0.05)	$ (0.06)	$ (0.09)	$ (0.13)

See accompanying notes to the unaudited interim financial statements.

KARNALYTE RESOURCES INC.

STATEMENTS OF CASH FLOWS

For the six months ended June 30,

(CAD thousands, unaudited)	2014	2013
Cash Flows from (used in) Operating Activities		
Net loss for the period	$ (2,601)	$ (3,326)
Add/deduct:		
Depreciation and amortization	409	404
Stock-based compensation expense	184	1,109
Net finance income	(350)	(572)
Interest income received	360	219
Changes in non-cash working capital:		
Trade and other receivables	(163)	49
Trade and other payables	501	(409)
Prepaid expenses	43	7
Purchase of shares pursuant to compensation plans	-	(6)
	(1,617)	(2,525)
Cash Flows from (used in) Investing Activities		
Additions to intangible assets	(145)	(521)
Proceeds on sale of intangible assets	1,244	-
Additions to capital assets	(1,199)	(8,062)
Proceeds on disposition of capital assets	25	-
	(75)	(8,583)
Cash Flows from (used in) Financing Activities		
Issuance of common shares	-	44,745
Share issue costs	-	(2,432)
Deferred financing costs	(66)	(443)
	(66)	41,870
Effect of foreign exchange on cash	6	348
Change in cash	(1,752)	31,110
Cash, beginning of period	46,161	25,115
Cash and cash equivalents, end of period	$ 44,409	$ 56,225

See accompanying notes to the unaudited interim financial statements.

KARNALYTE RESOURCES INC.

STATEMENTS OF CHANGES IN EQUITY

For the six months ended June 30,
(Expressed in CAD thousands, unaudited)

	2014			2013		
	Number		**Amount**	**Number**		**Amount**
Share Capital						
Balance, beginning of period	27,477	$	129,774	21,989	$	87,473
Common shares issued (note 6(b))	-		-	5,490		44,746
Treasury shares purchased	-		-	(1)		(6)
Vesting of employee share ownership plan	1		6	-		-
Share issue costs	-		-	-		(2,432)
Balance, end of period	27,478		129,780	27,478		129,781
Contributed Surplus						
Balance, beginning of period			7,778			4,906
Share-based payment expense (note 7)			371			1,557
Vesting of employee share ownership plan			(6)			-
Balance, end of period			8,143			6,463
Deficit						
Balance, beginning of period			(26,976)			(20,234)
Loss for the period			(2,601)			(3,326)
Balance, end of period			(29,577)			(23,560)
Total Shareholders' Equity						
Balance, end of period		$	108,346		$	112,684

See accompanying notes to the financial statements.

1. Reporting entity

Karnalyte Resources Inc. (the "Company" or "Karnalyte") is incorporated under the laws of the province of Alberta. The business of Karnalyte consists of the exploration and development of its property and planned construction of a production facility and development of a potash mine. The property is situated in Saskatchewan, south of Wynyard and contains a dominant zone of potash and magnesium minerals. The recoverability of amounts recorded as mineral properties and deferred exploration and development costs is dependent upon the discovery of economically recoverable reserves, the ability of the Company to obtain necessary financing to develop the property and upon future profitable production and the sale thereof.

The Company is in its pre-development phase and therefore there is no certainty that the Company will be able to raise additional funds to obtain the necessary capital to move forward to the production stage. The Company's operating segments have been identified as the individual mineral reserve streams. The Company has currently identified two operating segments, potash and magnesium; however as investment in the magnesium segment is negligible they are grouped as one reporting segment for financial reporting purposes.

The Company's address is 403 – 235 Milligan Drive, Okotoks, Alberta T1S 0B8.

2. Basis of preparation

(a) Statement of compliance

These unaudited financial statements have been prepared by management in accordance with International Accounting Standard ("IAS") 34, Interim Financial Reporting, as issued by the International Accounting Standards Board. In preparing these interim financial statements the Company applied the same accounting policies as disclosed in the year-end financial statements dated December 31, 2013. These statements do not include all information or disclosures normally provided in annual statements. These interim statements should be read in conjunction with the audited annual financial statements and related notes.

These financial statements were authorized for issue by the Board of Directors on August 12, 2014.

(b) Reclassification

Certain amounts have been reclassified to conform to current period presentation.

3. Changes in accounting policies

During the first quarter of 2014, the Company adopted the following standards:

(a) IAS 32 – Financial Instruments: Presentation

The amendments to IAS 32 pertain to the application guidance on the offsetting of financial assets and financial liabilities. The changes focus on four main areas: the meaning of "currently has a legally enforceable right of set-off", the application of simultaneous realization and settlement, the offsetting of collateral amounts and the unit of account for applying the offsetting requirements. There was no impact to the Company on adoption of this standard.

(b) *IFRIC 21 – Levies*
The interpretation provided guidance on accounting for levies in accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets. IFRIC 21 defines a levy as an outflow from an entity imposed by a government in accordance with legislation and confirms that an entity recognizes a liability for a levy only when the triggering event specified in the legislation occurs. The Company's current accounting treatment for levies is consistent with the requirements of IFRIC 21, such that the adoption of IFRIC 21 has had no impact on the financial reporting.

(c) *New standard not yet adopted:*
IFRS 9 – Financial Instruments
The standard is the first step in the process to replace IAS 39, Financial instruments: recognition and measurement. IFRS 9 introduces new requirements for classifying and measuring financial assets and liabilities and carries over from the requirements of IAS 39, Financial instruments: recognition and measurement, derecognition of financial assets and financial liabilities. The extent of the impact of adoption of these standards has not yet been determined.

IFRS 15 – Revenue
On May 28, 2014, the IAS board issued IFRS 15 "Revenue", which specifies how and when to recognize revenue as well as requiring entities to provide users of financial statements with more disclosure. The standard supersedes IAS 18 "Revenue", IAS 11 "Construction contracts", and related interpretations. IFRS 15 will be effective for annual periods beginning on or after January 1, 2017. Application of the standard is mandatory and early adoption is permitted. Karnalyte is currently evaluating the impact of adopting IFRS 15 on its consolidated financial statements.

(All tabular amounts are in CAD thousands except per share amounts, unaudited)

4. Capital assets

	Land and Buildings	Vehicles	Processing and other Equipment	Assets Under Construction	Total
Cost:					
Balance at January 1, 2013	$ 537	$ 142	$ 3,440	$ 3,466	$ 7,585
Additions	181	-	295	12,622	13,098
Dispositions	(77)	-	(14)	-	(91)
Balance at December 31, 2013	641	142	3,721	16,088	20,592
Additions	-	-	-	882	882
Dispositions	-	(42)	-	-	(42)
Balance at June 30, 2014	$ 641	$ 100	$ 3,721	$ 16,970	$ 21,432
Accumulated depreciation:					
Balance at January 1, 2013	$ 109	$ 12	$ 1,060	$ -	$ 1,181
Depreciation for the period	77	45	621	-	743
Dispositions	(69)	-	(8)	-	(77)
Balance at December 31, 2013	117	57	1,673	-	1,847
Depreciation for the period	38	18	320	-	376
Dispositions	-	(17)	-	-	(17)
Balance at June 30, 2014	$ 155	$ 58	$ 1,993	$ -	$ 2,206
Carrying amounts:					
December 31, 2013	$ 524	$ 85	$ 2,048	$ 16,088	$ 18,745
June 30, 2014	$ 486	$ 42	$ 1,728	$ 16,970	$ 19,226

Assets under construction will not be depreciated until construction is complete and the asset is placed in service. During the three and six months ended June 30, 2014 the Company capitalized employee remuneration of $285,000 and $588,000 (2013 - $291,000 and $522,000) and stock-based compensation expense of $60,000 and $179,000 (2013 - $265,000 and $422,000) to capital assets.

(All tabular amounts are in CAD thousands except per share amounts, unaudited)

5. Intangible exploration and evaluation assets and other intangible assets

	Mineral Properties	Process Patents	Computer Software	Total
Cost:				
Balance at January 1, 2013	$ 42,983	$ 117	$ 250	$ 43,350
Additions	987	22	27	1,036
Sale of assets	(1,181)	-	-	(1,181)
Balance at December 31, 2013	42,789	139	277	43,205
Additions	145	9	-	154
Sale of Assets	(63)	-	-	(63)
Balance at June 30, 2014	$ 42,871	$ 148	$ 277	$ 43,296
Amortization and impairment losses:				
Balance at January 1, 2013	$ -	$ 13	$ 140	$ 153
Amortization for the year	-	10	91	101
Balance at December 31, 2013	-	23	231	254
Amortization for the period	-	-	33	33
Balance at June 30, 2014	$ -	$ 23	$ 264	$ 287
Carrying amounts:				
December 31, 2013	$ 42,789	$ 116	$ 46	$ 42,951
June 30, 2014	$ 42,871	$ 125	$ 13	$ 43,009

During the three and six months ended June 30, 2014 the Company capitalized employee remuneration of $28,000 and $56,000 (2013 - $22,000 and $43,000) and stock-based compensation expense of $3,000 and $9,000 (2013 - $13,000 and $26,000) to intangible assets.

6. Share capital

(a) Authorized

As at June 30, 2014 and 2013 the Company was authorized to issue an unlimited number of common shares. The holders of common shares are entitled to receive dividends as declared by the Company and are entitled to one vote per share. No dividends were declared in any of the periods presented.

The Company is also entitled to issue an unlimited number of preferred shares. There are no preferred shares issued as at June 30, 2014 or 2013.

(All tabular amounts are in CAD thousands except per share amounts, unaudited)

(b) Earnings per share

Basic earnings per share were calculated as follows:

	Three months ended		Six months ended	
	2014	2013	2014	2013
Loss for the period ending June 30,	$ (1,347)	$ (1,675)	$ (2,601)	$ (3,326)
Weighted average number of common shares:				
Issued common shares at beginning of period	27,477	21,989	27,477	21,989
Common shares issued	-	5,490	-	3,488
Treasury shares issued pursuant to ESOP	1	-	1	-
Weighted average number of common shares:	27,478	27,479	27,478	25,477
Basic loss per share	$ (0.05)	$ (0.06)	$ (0.09)	$ (0.13)

Basic loss per share is calculated using the weighted average number of shares outstanding during the year. Diluted per share amounts are equal to basic per share amounts due to the Company incurring a net loss for the period. Excluded from the diluted per share calculations were 1,959,500 (2013 – 2,249,500) options as their effect would have been anti-dilutive.

7. Stock-based compensation expense

The Company has a stock option plan under which directors, officers and non-employees of the Company are eligible to receive stock options. The aggregate number of common shares to be issued upon the exercise of all stock options granted under the plan shall not exceed 10% of the issued common shares of the Company at the time of granting of the options. Options granted under the plan generally have a term of two to five years and vest at terms to be determined by the directors at the time of grant. The exercise price of each option shall be determined by the directors at the time of grant but shall not be less than the price permitted by the policies of the stock exchange on which the Company's common shares are then listed.

The number and weighted average exercise prices of share options are as follows:

	June 30, 2014		December 31, 2013	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at beginning of period	2,095	8.86	1,288	9.72
Issued during the period	-	-	1,029	7.93
Expired during the period	(4)	7.95	(78)	11.61
Forfeited during the period	(131)	7.95	(144)	8.44
Outstanding	1,960	8.92	2,095	8.86
Exercisable	1,628	9.13	1,215	9.20

(All tabular amounts are in CAD thousands except per share amounts, unaudited)

Number of Options Outstanding		Exercise Price	Remaining Life (yrs)		Grant Date Fair Value	Exercisable Options		Exercise Price
391		8.60	1.47		4.24	391		8.60
25		10.99	2.48		5.32	25		10.99
760		10.05	2.80		4.62	760		10.05
769		7.95	3.73		3.00	445		7.95
15		6.73	3.99		1.35	8		6.73
1,960	$	8.92	2.91	$	3.89	1,629	$	9.13

8. Cash flows from (used in) Investing Activities

	Intagible Exploration and Evaluation and Other Intangible Assets		Capital Assets	
	2014	2013	2014	2013
Cash Flows from (used in) Investing Activities				
Additions	$ (154)	$ (561)	$ (882)	$ (6,968)
Changes in non-cash working capital				
Trade and other receivables	3	-	-	-
Trade and other payables	-	(109)	(496)	(1,337)
Prepaid expenses	7	16	-	-
Stock based compensation capitalized	9	26	179	422
Asset retirement obligations	(10)	13	-	-
	$ (145)	$ (615)	$ (1,199)	$ (7,883)

9. Commitments

The following are the commitments of the company as at June 30, 2014:

	Contractual cash flows	Less than one year	Two - three years	Four - five years	More than five years
Trade and other payables	$ 615	$ 615	$ -	$ -	$ -
Office lease	679	265	402	12	-
Permit/lease on mineral property	2,680	60	208	341	2,071
Project contracts	1,610	1,610	-	-	-
	$ 5,584	$ 2,550	$ 610	$ 353	$ 2,071

The company has entered into an engagement letter pursuant to which it has engaged BNP Paribas and Natixis to act as lead arrangers for a senior secured project finance facility of up to US $300 million. If the facility is terminated the lead arrangers are entitled to a break fee in the amount of $500 thousand each.

10. Risk management

Financial instruments included in the statements of financial position consist of cash, trade and other receivables, restricted cash, and trades and other payables. The fair values of these financial instruments approximate their carrying amounts due to the short term maturity of the instruments.

11. Subsequent event

On July 4, 2014 the Company granted 695,000 stock options. The fair value of the options was estimated on the date of grant using the Black-Scholes option-pricing model. In addition, there were 651,000 options that were re-priced. The options vest over two years, have a life of five years and range in strike price from $1.27 to $1.90.