

Condensed Interim Unaudited Financial Statements of
KARNALYTE RESOURCES INC.

Three and six months ended June 30, 2012

KARNALYTE RESOURCES INC.

STATEMENTS OF FINANCIAL POSITION

ASSETS

As at	June 30, 2012	December 31, 2011
Current assets		
Cash	\$ 31,472,099	\$ 34,251,529
Trade and other receivables	188,325	711,774
Prepaid expenses	111,162	99,807
Deferred financing costs (note 4)	500,152	102,893
	<u>32,271,738</u>	<u>35,166,003</u>
Restricted cash	375,000	375,000
Capital assets (note 5)	2,967,854	3,223,921
Intangible exploration and evaluation and other assets (note 6)	40,797,335	37,082,201
	<u>76,411,927</u>	<u>75,847,125</u>
ASSETS	\$ 76,411,927	\$ 75,847,125

LIABILITIES

Current liabilities		
Trade and other payables	\$ 1,763,818	\$ 2,365,895
Capital lease liability	3,452	6,904
	<u>1,767,270</u>	<u>2,372,799</u>
Provisions (note 7)	194,630	185,617
Total liabilities	<u>1,961,900</u>	<u>2,558,416</u>

SHAREHOLDERS' EQUITY

Share capital (note 8)	86,547,109	82,105,674
Warrants and rights	149,430	934,950
Contributed surplus	3,969,670	3,276,698
Deficit	(16,216,182)	(13,028,613)
Total shareholders' equity	<u>74,450,027</u>	<u>73,288,709</u>
LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 76,411,927	\$ 75,847,125

See accompanying notes to the interim financial statements.

KARNALYTE RESOURCES INC.

STATEMENTS OF COMPREHENSIVE LOSS

Three and six months ended June 30,

	Three months ended		Six months ended	
	2012	2011	2012	2011
Expenses				
General and administrative	\$ 782,363	\$ 725,489	\$ 1,580,670	\$ 1,535,914
Depreciation and amortization	222,714	149,112	416,059	205,768
Share-based payments (note 10)	564,391	434,753	694,912	892,957
Transaction costs	-	-	108,984	-
Restructuring expenditures	735,199	-	735,199	-
Other income and expenses	(105,226)	(61,429)	(130,904)	(83,909)
	2,199,441	1,247,925	3,404,920	2,550,730
Finance income	(113,808)	(120,762)	(231,583)	(158,950)
Finance expense	11,206	45,066	14,235	65,050
Net finance income	(102,602)	(75,696)	(217,348)	(93,900)
Comprehensive loss	(2,096,839)	(1,172,229)	(3,187,572)	(2,456,830)
Loss per share (note 9)				
Basic and diluted	\$ (0.10)	\$ (0.06)	\$ (0.15)	\$ (0.12)

See accompanying notes to the interim financial statements.

KARNALYTE RESOURCES INC.**STATEMENTS OF CASH FLOWS**

Six months ended June 30,

	<u>2012</u>	<u>2011</u>
Cash Flows from (used in) Operating Activities		
Net loss for the period	\$ (3,187,572)	\$ (2,456,830)
Add/deduct:		
Depreciation and amortization	416,059	205,768
Share-based payment expense	694,912	892,957
Net finance and other income	(348,252)	(93,900)
Interest and other income received	362,487	158,950
Changes in non-cash working capital:		
Trade and other receivables	146,934	(831,840)
Trade and other payables	(889,874)	126,016
Prepaid expenses	(11,104)	17,767
	<u>(2,816,410)</u>	<u>(1,981,112)</u>
Cash Flows from (used in) Investing Activities		
Additions to intangible assets	(2,931,604)	(14,369,955)
Additions to capital assets	(124,738)	(2,721,563)
	<u>(3,056,342)</u>	<u>(17,091,518)</u>
Cash Flows from (used in) Financing Activities		
Issuance of common shares	-	5,008,117
Exercise of options and warrants	3,613,731	-
Share issue costs	-	(786,464)
Deferred financing costs	(508,646)	-
	<u>3,105,085</u>	<u>4,221,653</u>
Effect of foreign exchange on cash	(11,763)	(63,041)
Change in cash	(2,779,430)	(14,914,018)
Cash, beginning of period	34,251,529	59,000,457
Cash and cash equivalents, end of period	<u>\$ 31,472,099</u>	<u>\$ 44,086,439</u>

See accompanying notes to the interim financial statements.

KARNALYTE RESOURCES INC.

STATEMENTS OF CHANGES IN EQUITY

Six months ended June 30,

	2012		2011	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
Share Capital				
Balance, beginning of period	21,418,536	\$82,105,674	20,093,740	\$72,313,190
Common shares issued	-	-	470,000	4,042,000
Common shares issued on exercise of share options	141,325	735,875	135,600	678,000
Common shares issued on exercise of broker warrants	309,053	2,657,856	33,502	288,117
Transfer from contributed surplus on options exercised	-	262,184	-	230,125
Transfer from warrants on broker warrants exercised	-	785,520	-	85,158
Share issue costs	-	-	-	(325,471)
Balance, end of period	21,868,914	86,547,109	20,732,842	77,311,119
Warrants and Rights				
Balance, beginning of period	368,528	934,950	585,624	1,273,605
Broker warrants and rights issued	-	-	28,200	71,780
Broker warrants and rights exercised	(309,053)	(785,520)	(33,502)	(85,158)
Balance, end of period	59,475	149,430	580,322	1,260,227
Contributed Surplus				
Balance, beginning of period		3,276,698		2,359,264
Share-based payment expense (note 10)		1,082,847		1,108,903
Transfer to share capital on exercise		(262,184)		(230,125)
Option adjustments		(127,691)		
Balance, end of period		3,969,670		3,238,042
Deficit				
Balance, beginning of period		(13,028,610)		(7,674,777)
Loss for the period		(3,187,572)		(2,456,830)
Balance, end of period		(16,216,182)		(10,131,607)
Total Shareholders' Equity				
Balance, end of period		\$74,450,027		\$71,677,781

See accompanying notes to the financial statements.

KARNALYTE RESOURCES INC.

Notes to Financial Statements

Three and six months ended June 30, 2012 and 2011

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.

In preparing these interim financial statements the company applied the same accounting policies as disclosed in the year-end financial statements dated December 31, 2011. These statements do not include all information or disclosures normally provided in annual statements. These interim statements should be read in conjunction with our audited financial statements and related notes.

The Company is in its pre-development 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 has sufficient cash to meet its short-term corporate operating and capital requirements.

The Company’s address is 104 – 26 Crystalridge Drive, Okotoks, Alberta T1S 2C3.

2. **Basis of preparation:**

(a) Statement of compliance:

This condensed interim financial report has been prepared in accordance with IAS 34 Interim Financial Reporting. Selected explanatory notes are included to explain events and transactions that are significant to an understanding of the changes in financial position and performance of the Company since the last annual financial statements as at and for the year ended December 31, 2011. This condensed interim financial report does not include all the information required for full annual financial statements prepared in accordance with International Financial Reporting Standards.

This condensed interim financial report was approved by the Board of Directors on August 10, 2012.

(b) Judgements and estimates:

Preparing the interim financial report requires Management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expense. Actual results may differ from these estimates.

In preparing this condensed interim financial report, significant judgements made by Management in applying the Company’s accounting policies and the key sources of estimation uncertainty were the same as those that applied to the financial statements as at and for the year ended December 31, 2011.

KARNALYTE RESOURCES INC.

Notes to Financial Statements

Three and six months ended June 30, 2012 and 2011

3. Nature of general and administrative expenses

We are required to present our financial performance by nature or by function. We have presented our financial performance by the underlying nature of the expense with the exception of general and administrative expenses. Had the general and administrative expenses been presented by their nature, the Company would disclose payroll expense and employee benefits of \$328,642 and \$722,861 (2011 – \$365,654 and \$729,241) and office and sundry expense of \$453,721 and \$857,809 (2011 - \$359,835 and \$806,673) for the three and six month periods ending June 30, 2012.

4. Deferred financing:

Deferred financing costs were incurred as a result of the Company continuing to pursue debt financing. These costs will be deferred until the debt has been issued or the issuance is no longer considered probable.

5. Capital assets:

	Land and Buildings	Processing and other Equipment	Total
Cost:			
Balance at January 1, 2011	\$ 384,118	\$ 131,204	\$ 515,322
Additions	-	3,278,718	3,278,718
Dispositions	-	(35,281)	(35,281)
Balance at December 31, 2011	384,118	3,374,641	3,758,759
Additions	12,948	111,790	124,738
Balance at June 30, 2012	\$ 397,066	\$ 3,486,431	\$ 3,883,497
Accumulated depreciation:			
Balance at January 1, 2011	\$ 21,142	\$ 34,804	\$ 55,946
Depreciation for the period	10,378	473,798	484,176
Dispositions	-	(5,284)	(5,284)
Balance at December 31, 2011	31,520	503,318	534,838
Depreciation for the period	26,066	354,739	380,805
Balance at June 30, 2012	\$ 57,586	\$ 858,057	\$ 915,643
Carrying amounts:			
December 31, 2011	\$ 352,598	\$ 2,871,323	\$ 3,223,921
June 30, 2012	\$ 339,480	\$ 2,628,374	\$ 2,967,854

KARNALYTE RESOURCES INC.

Notes to Financial Statements

Three and six months ended June 30, 2012 and 2011

6. Intangible exploration and evaluation assets and other intangible assets:

	Mineral Properties	Process Patents	Computer Software	Total
Cost:				
Balance at January 1, 2011	\$ 10,651,252	\$ 62,017	\$ 56,448	\$ 10,769,717
Additions	26,322,544	27,009	35,638	26,385,191
Balance at December 31, 2011	36,973,796	89,026	92,086	37,154,908
Additions	3,584,927	9,488	155,974	3,750,389
Balance at June 30, 2012	\$ 40,558,723	\$ 98,514	\$ 248,060	\$ 40,905,297
Amortization and impairment losses:				
Balance at January 1, 2011	\$ -	\$ 5,589	\$ 15,850	\$ 21,439
Amortization for the year	-	7,715	43,553	51,268
Balance at December 31, 2011	-	13,304	59,403	72,707
Amortization for the period	-	409	34,846	35,255
Balance at June 30, 2012	\$ -	\$ 13,713	\$ 94,249	\$ 107,962
Carrying amounts:				
December 31, 2011	\$ 36,973,796	\$ 75,722	\$ 32,683	\$ 37,082,201
June 30, 2012	\$ 40,558,723	\$ 84,801	\$ 153,811	\$ 40,797,335

During the three and six months ended June 30, 2012 the Company capitalized employee remuneration of \$234,487 and \$455,941 (2011 - \$212,928 and \$402,325) and share-based payments of \$227,937 and \$260,246 (2011 - \$105,427 and \$215,946).

7. Provisions:

	Decommissioning obligations
Balance at January 1, 2012	\$ 185,617
Changes in estimate	6,913
Accretion	2,100
Balance at June 30, 2012	\$ 194,630
Non-current	\$ 194,630

The undiscounted amount of estimated costs required to settle the obligations at June 30, 2012 is \$270,000 (December 31, 2011 - \$270,000). The estimated costs have been inflated at 2.0 percent and discounted at a risk free rate of 2.08 percent (June 30, 2011 – 3.36 percent) for the period ending June 30, 2012.

KARNALYTE RESOURCES INC.

Notes to Financial Statements

Three and six months ended June 30, 2012 and 2011

8. Share capital:

(c) *Authorized:*

As at June 30, 2012 and June 30, 2011 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 number of common shares outstanding are as follows:

	Three months ended		Six months ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Beginning balance as at January 1,	21,551,736	20,629,842	21,418,536	20,093,740
Common shares issued	-	-	-	470,000
Common shares issued on exercise of share options	8,125	103,000	141,325	135,600
Common shares issued on exercise of broker warrants	309,053	-	309,053	33,502
Outstanding at June 30,	21,868,914	20,732,842	21,868,914	20,732,842

The Company is also entitled to issue an unlimited number of preferred shares. There are no preferred shares issued as at June 30, 2012 or 2011.

9. Earnings per share:

Basic earnings per share was calculated as follows:

	Three months ended		Six months ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Loss for the period ending June 30,	\$ (2,096,839)	\$ (1,172,229)	\$ (3,187,572)	\$ (2,456,830)
Weighted average number of common shares:				
Issued common shares at beginning of period	21,551,736	20,629,842	21,418,536	20,093,740
Share options exercised	6,339	21,154	121,595	29,926
Broker warrants exercised	91,246	-	45,623	21,286
Common shares issued	-	-	-	436,243
Weighted average number of common shares:	21,649,321	20,650,996	21,585,754	20,581,195
Basic loss per share	\$ (0.10)	\$ (0.06)	\$ (0.15)	\$ (0.12)

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 1,825,250 (2011 – 1,637,600) options and 59,475 (2011 – 580,322) broker warrants as their effect would have been anti-dilutive.

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10. Share-based payments:

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:

	2012		2011	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at January 1,	1,213,700	6.91	1,773,200	6.07
Issued during the period	945,000	10.05	-	-
Exercised during the period	(141,325)	5.20	(135,600)	5.00
Expired during the period	(30,000)	5.00	-	-
Forfeited during the period	(162,125)	9.63	-	-
Outstanding at June 30,	1,825,250	8.46	1,637,600	6.16
Exercisable at June 30,	890,875	6.96	1,241,600	5.38

The weighted average share price on the dates of exercise was \$10.07 per share during the period ended June 30, 2012 (2011 - \$10.54).

There were 945,000 options granted on April 18, 2012. The fair value of the options was estimated on the date of grant using the Black-Scholes option-pricing model. The options vest over two years and have a life of five years. The interest rate, volatility and dividend yield assumptions used in the calculation were 1.47%, 52% and nil respectively.

KARNALYTE RESOURCES INC.

Notes to Financial Statements

Three and six months ended June 30, 2012 and 2011

11. Commitments:

The following are the commitments of the company as at June 30, 2012:

	Contractual cash flows	Less than one year	Two - three years	Four - five years	More than five years
Non-derivative financial liabilities:					
Trade and other payables	\$1,763,818	\$1,763,818	\$ -	\$ -	\$ -
Capital lease	3,452	3,452	-	-	-
Office lease	877,650	326,050	285,600	266,000	-
Permit/lease on mineral property	668,816	57,508	67,300	67,300	476,708
Project contracts	834,035	834,035	-	-	-
	\$4,147,771	\$2,984,863	\$ 352,900	\$ 333,300	\$ 476,708

The Company has entered into contracts for various drilling, geological, consulting and debt financing services. The drilling contract requires a minimum commitment of 100 operating days to be completed by August 31, 2012. The Company expects to pay approximately \$700,000 at the end of the contract to complete its commitment which has been accrued as a payable in the current quarter.

The Company secured computer equipment by entering a capital lease on January 1, 2010. The lease carries a term of 36 months with an implicit interest rate of 13%. The present value of the minimum lease payments at inception was \$20,712.

The Company has also signed a lease agreement for the building space that was being used for management offices in Okotoks. The lease is paid on a monthly basis of \$18,325 and will expire on April 30, 2013.

The Company recently signed a lease for an office space in Saskatoon. Possession of this space will take place on August 1, 2012. The lease is paid on a monthly basis and includes both a basic rent of \$9,800 plus an occupancy cost of approximately \$3.00 per square foot per annum.