



Interim Unaudited Financial Statements

Three and six months ended June 30, 2013

KARNALYTE RESOURCES INC.

STATEMENTS OF FINANCIAL POSITION

ASSETS

As at	June 30, 2013	December 31, 2012
Current assets		
Cash	\$ 56,224,956	\$ 25,114,959
Trade and other receivables	176,493	225,363
Prepaid expenses	105,828	128,927
Deferred financing costs (note 5)	1,164,536	843,897
	<u>57,671,813</u>	<u>26,313,146</u>
Restricted cash	375,000	375,000
Capital assets (note 6)	13,107,994	6,404,557
Intangible exploration and evaluation and other assets (note 7)	43,710,479	43,197,551
	<u>114,865,286</u>	<u>76,290,254</u>
ASSETS	\$ 114,865,286	\$ 76,290,254

LIABILITIES

Current liabilities		
Trade and other payables	\$ 2,017,673	\$ 3,996,019
	<u>2,017,673</u>	<u>3,996,019</u>
Provisions	165,181	149,956
Total liabilities	<u>2,182,854</u>	<u>4,145,975</u>

SHAREHOLDERS' EQUITY

Share capital (note 8)	129,780,607	87,473,052
Contributed surplus	6,462,486	4,905,686
Deficit	(23,560,661)	(20,234,459)
Total shareholders' equity	<u>112,682,432</u>	<u>72,144,279</u>
LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 114,865,286	\$ 76,290,254

Commitments (note 10, note 8(d))

See accompanying notes to the financial statements.

KARNALYTE RESOURCES INC.

STATEMENTS OF COMPREHENSIVE LOSS

For the three and six months ended June 30,

	Three months ended		Six months ended	
	2013	2012	2013	2012
Expenses				
General and administrative	\$ 1,304,189	\$ 782,363	\$ 2,385,860	\$ 1,580,670
Depreciation and amortization	197,442	222,714	404,058	416,059
Share-based payments (note 9)	684,396	564,391	1,108,682	694,912
Transaction costs	-	-	-	108,984
Restructuring expenditures	-	735,199	-	735,199
Other income and expenses	8,563	(105,226)	(3,632)	(130,904)
	2,194,590	2,199,441	3,894,968	3,404,920
Finance income	(520,587)	(113,808)	(597,590)	(231,583)
Finance expense	1,960	11,206	28,824	14,235
Net finance income	(518,627)	(102,602)	(568,766)	(217,348)
Comprehensive loss	(1,675,963)	(2,096,839)	(3,326,202)	(3,187,572)
Loss per share (note 8(b))				
Basic and diluted	\$ (0.06)	\$ (0.10)	\$ (0.13)	\$ (0.15)

See accompanying notes to the financial statements.

KARNALYTE RESOURCES INC.

STATEMENTS OF CASH FLOWS

For the six months ended June 30,

	<u>2013</u>	<u>2012</u>
Cash Flows from (used in) Operating Activities		
Net loss for the period	\$ (3,326,202)	\$ (3,187,572)
Add/deduct:		
Depreciation and amortization	404,058	416,059
Share-based payment expense	1,108,682	694,912
Net finance and other income	(572,400)	(348,252)
Interest and other income received	219,417	362,487
Changes in non-cash working capital:		
Trade and other receivables	48,871	146,934
Trade and other payables	(409,492)	(889,874)
Prepaid expenses	7,269	(11,104)
Purchase of shares pursuant to compensation plans	(5,947)	-
	<u>(2,525,744)</u>	<u>(2,816,410)</u>
Cash Flows from (used in) Investing Activities		
Additions to intangible assets	(521,332)	(2,931,604)
Additions to capital assets	(8,061,886)	(124,738)
	<u>(8,583,218)</u>	<u>(3,056,342)</u>
Cash Flows from (used in) Financing Activities		
Issuance of common shares	44,745,994	-
Exercise of options and warrants	-	3,613,731
Share issue costs	(2,432,492)	-
Deferred financing costs	(443,479)	(508,646)
	<u>41,870,023</u>	<u>3,105,085</u>
Effect of foreign exchange on cash	348,936	(11,763)
Change in cash	31,109,997	(2,779,430)
Cash, beginning of period	25,114,959	34,251,529
Cash and cash equivalents, end of period	<u>\$ 56,224,956</u>	<u>\$ 31,472,099</u>

See accompanying notes to the financial statements.

KARNALYTE RESOURCES INC.

STATEMENTS OF CHANGES IN EQUITY

For the six months ended June 30,

	2013		2012	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
Share Capital				
Balance, beginning of period	21,988,704	\$ 87,473,052	21,418,536	\$ 82,105,674
Common shares issued (note 8(b))	5,490,306	44,745,994	-	-
Common shares issued on exercise of share options	-	-	141,325	735,875
Common shares issued on exercise of broker warrants	-	-	309,053	2,657,856
Treasury shares purchased	(928)	(5,941)	-	-
Transfer from contributed surplus on options exercised	-	-	-	262,184
Transfer from contributed surplus on broker warrants	-	-	-	785,520
Share issue costs	-	(2,432,498)	-	-
Balance, end of period	27,478,082	129,780,607	21,868,914	86,547,109
Warrants and Rights				
Balance, beginning of period	-	-	368,528	934,950
Broker warrants and rights exercised	-	-	(309,053)	(785,520)
Balance, end of period	-	-	59,475	149,430
Contributed Surplus				
Balance, beginning of period		4,905,686		3,276,698
Share-based payment expense (note 9)		1,556,800		1,082,847
Transfer to share capital on exercise		-		(262,184)
Option adjustments		-		(127,691)
Balance, end of period		6,462,486		3,969,670
Deficit				
Balance, beginning of period		(20,234,459)		(13,028,610)
Loss for the period		(3,326,202)		(3,187,572)
Balance, end of period		(23,560,661)		(16,216,182)
Total Shareholders' Equity				
Balance, end of period		\$ 112,682,432		\$ 74,450,027

See accompanying notes to the financial statements.

KARNALYTE RESOURCES INC.

Notes to Financial Statements

Three and six months ended June 30, 2013 and 2012

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 has sufficient cash to meet its short-term corporate operating and capital requirements.

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

2. **Statement of compliance**

These unaudited interim financial statements are prepared in compliance with IAS 34 “Interim Financial Reporting”. In preparing these interim financial statements the Company applied the same accounting policies as disclosed in the year-end financial statements dated December 31, 2012. 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.

3. **Changes in accounting policies**

During the first quarter of 2013, the Company adopted the following standards:

- IFRS 11 “Joint arrangements” outlines the accounting treatment for joint arrangements, notably joint operations and joint ventures, to be applied retrospectively. This new standard became effective on January 1, 2013. There was no impact to the Company on adoption of this standard.
- IFRS 13 “Fair value measurement” defines fair value, provides guidance on measuring fair value and outlines disclosure requirements for fair value measurements. This standard applies when another IFRS standard requires fair value measurements or disclosures, with some exceptions including IFRS 2 “Share based payments” and IAS 17 “Leases”. This new standard became effective and was applied prospectively on January 1, 2013. There was no measurement impact to the Company on adoption of this standard. Refer to note 9 for the additional disclosure required.

4. **Judgement 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, 2012.

KARNALYTE RESOURCES INC.

Notes to Financial Statements

Three and six months ended June 30, 2013 and 2012

5. 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. Such financing costs will be recognized in profit or loss if the financing is no longer considered probable.

6. Capital assets

	Land and Buildings	Vehicles	Processing and other Equipment	Assets Under Construction	Total
Cost:					
Balance at January 1, 2012	\$ 455,785	\$ -	\$ 3,302,972	\$ -	\$ 3,758,757
Additions	81,388	141,898	137,229	3,466,078	3,826,593
Dispositions	-	-	-	-	-
Balance at December 31, 2012	537,173	141,898	3,440,201	3,466,078	7,585,350
Additions	122,423	-	28,582	6,833,814	6,984,819
Balance at June 30, 2013	\$ 659,596	\$ 141,898	\$ 3,468,783	\$ 10,299,892	\$ 14,570,169
Accumulated depreciation:					
Balance at January 1, 2012	\$ 65,356	\$ -	\$ 469,480	\$ -	\$ 534,836
Depreciation for the period	43,311	11,825	590,821	-	645,957
Dispositions	-	-	-	-	-
Balance at December 31, 2012	108,667	11,825	1,060,301	-	1,180,793
Depreciation for the period	(38,174)	22,394	297,162	-	281,382
Balance at June 30, 2013	\$ 70,493	\$ 34,219	\$ 1,357,463	\$ -	\$ 1,462,175
Carrying amounts:					
December 31, 2012	\$ 428,506	\$ 130,073	\$ 2,379,900	\$ 3,466,078	\$ 6,404,557
June 30, 2013	\$ 589,103	\$ 107,679	\$ 2,111,320	\$ 10,299,892	\$ 13,107,994

KARNALYTE RESOURCES INC.

Notes to Financial Statements

Three and six months ended June 30, 2013 and 2012

7. Intangible exploration and evaluation assets and other intangible assets

	Mineral Properties	Process Patents	Computer Software	Total
Cost:				
Balance at January 1, 2012	\$ 36,973,796	\$ 89,026	\$ 92,086	\$ 37,154,908
Additions	6,009,602	27,729	157,789	6,195,120
Balance at December 31, 2012	42,983,398	116,755	249,875	43,350,028
Additions	518,514	16,144	26,910	561,568
Balance at June 30, 2013	\$ 43,501,912	\$ 132,899	\$ 276,785	\$ 43,911,596
Amortization and impairment losses:				
Balance at January 1, 2012	\$ -	\$ 13,304	\$ 59,403	\$ 72,707
Amortization for the year	-	(693)	80,463	79,770
Balance at December 31, 2012	-	12,611	139,866	152,477
Amortization for the period	-	3,219	45,421	48,640
Balance at June 30, 2013	\$ -	\$ 15,830	\$ 185,287	\$ 201,117
Carrying amounts:				
December 31, 2012	\$ 42,983,398	\$ 104,144	\$ 110,009	\$ 43,197,551
June 30, 2013	\$ 43,501,912	\$ 117,069	\$ 91,498	\$ 43,710,479

During the three and six months ended June 30, 2013 the Company capitalized employee remuneration of \$292,992 and \$547,367 (2012 - \$234,487 and \$455,941) and share-based payments of \$278,405 and \$448,118 (2012 - \$227,937 and \$260,246).

8. Share capital

(a) Authorized

As at June 30, 2013 and December 31, 2012 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.

KARNALYTE RESOURCES INC.

Notes to Financial Statements

Three and six months ended June 30, 2013 and 2012

(b) Earnings per share

Basic earnings per share were calculated as follows:

	Three months ended		Six months ended	
	2013	2012	2013	2012
Loss for the period ending June 30,	\$ (1,675,963)	\$ (2,096,839)	\$ (3,326,202)	\$ (3,187,572)
Weighted average number of common shares:				
Issued common shares at beginning of period	21,988,704	21,551,736	21,988,704	21,418,536
Share options exercised	-	6,339	-	121,595
Broker warrants exercised	-	91,246	-	45,623
Common shares issued	5,490,306	-	3,488,316	-
Common shares issued	(41)	-	(21)	-
Weighted average number of common shares:	27,478,969	21,649,321	25,476,999	21,585,754
Basic loss per share	\$ (0.06)	\$ (0.10)	\$ (0.13)	\$ (0.15)

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 2,249,500 (2012 – 1,825,250) options and nil (2012 – 59,475) broker warrants as their effect would have been anti-dilutive.

(c) Employee share ownership plan

The Company implemented an employee share ownership plan on June 1, 2013. Under the terms of the plan, employees may contribute up to a maximum of 5% of their gross pay and acquire voting shares of the Company at the current fair market value of such shares and the Company matches every dollar contributed by each employee. The shares purchased by the Company are restricted for one year from the date of acquisition. Shares purchased under the program are recognized as treasury shares and are offset against share capital until they vest. The cost of the shares is recognized over a one year period from the date of acquisition as share based payment expense. The Company's share of the contributions in the quarter ended June 30, 2013 amounted to \$5,941 (2012 - \$nil) and is recorded as compensation expense within the Statement of Comprehensive Loss.

(d) Private placement

On March 7, 2013 the Company closed a non-brokered private placement financing with Gujarat State Fertilizers & Chemicals ("GSFC") for \$44,745,994 in exchange for 5,490,306 common shares which represents a 19.98% ownership stake in the Company. Along with the financing, GSFC has also committed to an off-take agreement for the purchase of approximately 350,000 tonnes per year of potash increasing to 600,000 tonnes per year for a period of 20 years from the commencement of commercial production.

The Company is obligated to issue an additional 555,555 common shares to GSFC if commercial production has not commenced on or before October 1, 2016.

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9. 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:

	June 30, 2013		December 31, 2012	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at beginning of period	1,287,500	9.72	1,213,700	6.91
Issued during the period	1,029,000	7.93	-	-
Exercised during the period	-	-	(133,200)	5.00
Expired during the period	(6,250)	8.89	(30,000)	5.00
Forfeited during the period	(60,750)	8.60	-	-
Outstanding	2,249,500	8.94	1,050,500	7.21
Exercisable	867,500	9.57	786,500	6.74

Number of Options		Remaining Life (yrs)	Grant Date Fair Value	Exercisable	
Outstanding	Exercise Price			Options	Exercise Price
407,500	8.60	2.47	4.22	407,500	8.60
805,000	10.05	3.80	4.62	410,000	10.05
25,000	10.99	3.48	5.32	25,000	10.99
25,000	16.22	3.38	7.18	25,000	16.22
972,000	7.95	4.73	3.03	-	7.95
15,000	6.73	4.99	1.35	-	6.73
2,249,500	\$ 8.94	3.96	\$ 3.89	867,500	\$ 9.57

There were 1,014,000 options granted on March 21, 2013 and 15,000 options granted on June 24, 2013. The fair value of the options was estimated on the date of grant using the Black-Scholes option-pricing model. The options granted in 2013 vest over two years and have a life of five years. The interest rate, volatility, dividend yield and forfeiture rate assumptions used in the calculation were 1.02% - 1.25%, 42% - 49%, nil and 4% - 6% respectively.

KARNALYTE RESOURCES INC.

Notes to Financial Statements

Three and six months ended June 30, 2013 and 2012

10. Commitments

The following are the commitments of the company as at June 30, 2013:

	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	\$ 2,017,673	\$ 2,017,673	\$ -	\$ -	\$ -
Office lease	931,369	265,238	520,573	145,558	-
Permit/lease on mineral property	684,113	41,983	122,300	73,967	445,863
Project contracts	2,376,885	2,376,885	-	-	-
	\$ 6,010,040	\$ 4,701,779	\$ 642,873	\$ 219,525	\$ 445,863

11. 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. During the quarter ended June 30, 2013, the Company moved \$30 million CAD to a high interest USD savings account in an effort to mitigate risk of foreign exchange fluctuations.