



FORTUNA
SILVER MINES INC.

FINANCIAL REVIEW

Fiscal Year Ended December 31, 2010

FORTUNA SILVER MINES INC.

CONSOLIDATED FINANCIAL STATEMENTS

Years Ended December 31, 2010 and 2009

As at March 23, 2011

(Expressed in thousands of United States Dollars, unless otherwise stated)

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Independent Auditor's Report

To the Shareholders of Fortuna Silver Mines Inc.

We have audited the accompanying consolidated financial statements of Fortuna Silver Mines Inc., which comprise the consolidated balance sheets as at December 31, 2010 and 2009, and the consolidated statements of operations, comprehensive income, shareholders' equity and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purposes of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Fortuna Silver Mines Inc. as at December 31, 2010 and 2009 and the results of its operations and cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(Signed) Deloitte & Touche LLP

Chartered Accountants
Vancouver, British Columbia
March 23, 2011

FORTUNA SILVER MINES INC.
CONSOLIDATED BALANCE SHEETS
AS AT DECEMBER 31,
(Expressed in thousands of US Dollars)

	Notes	2010	2009
ASSETS			
CURRENT			
Cash and cash equivalents		\$ 70,298	\$ 30,763
Short term investments	4	20,509	6,034
Accounts receivable and prepaid expenses	6	13,454	8,635
GST/HST and value added tax receivables		3,542	601
Inventories	7	4,034	2,329
		111,837	48,362
DEPOSITS ON LONG TERM ASSETS	8	4,533	16
PROPERTY, PLANT AND EQUIPMENT	9	35,763	17,233
MINERAL PROPERTIES	10	91,050	74,127
		\$ 243,183	\$ 139,738
LIABILITIES			
CURRENT			
Accounts payable and accrued liabilities	11	\$ 13,496	\$ 8,083
Due to related parties	12	40	49
Derivatives	5	133	3,055
Current portion of long term liability	13 a)	1,083	1,038
		14,752	12,225
LONG TERM LIABILITY	13	3,166	1,454
ASSET RETIREMENT OBLIGATION	14	4,924	2,529
FUTURE INCOME TAX LIABILITY	15	14,333	10,973
		37,175	27,181
SHAREHOLDERS' EQUITY			
SHARE CAPITAL		180,403	104,701
CONTRIBUTED SURPLUS		11,116	14,315
RETAINED EARNINGS (DEFICIT)		3,597	(9,357)
ACCUMULATED OTHER COMPREHENSIVE INCOME		10,892	2,898
		14,489	(6,459)
		206,008	112,557
		\$ 243,183	\$ 139,738
Commitments and contingencies	18		
Subsequent event	22		

APPROVED BY THE DIRECTORS:

"Jorge Ganoza Durant", Director
Jorge Ganoza Durant

"Robert R. Gilmore" Director
Robert R. Gilmore

The accompanying notes are an integral part of these audited consolidated financial statements

FORTUNA SILVER MINES INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31,
(Expressed in thousands of US Dollars, except for share and per share amounts)

	Notes	2010	2009
Sales		\$ 74,056	\$ 51,428
Cost of sales		22,270	17,755
Depletion, depreciation and accretion		6,859	5,944
MINE OPERATING INCOME		44,927	27,729
Selling, general and administrative expenses	12	14,789	9,558
Stock-based compensation (recovery) expense	16 c)	(416)	2,707
Write-off of deferred exploration costs		443	1,081
		14,816	13,346
OPERATING INCOME		30,111	14,383
Interest and other (expenses) income		(379)	433
Interest and finance (expenses)		(544)	(160)
Net gain (loss) on commodity contracts		736	(7,356)
(Loss) on disposal of property, plant and equipment		(27)	(101)
(Loss) on disposal of mineral property		(100)	-
(Loss) on disposal of investment		(119)	(236)
Foreign exchange (loss)		(2,703)	(651)
		(3,136)	(8,071)
INCOME BEFORE INCOME TAXES AND NON-CONTROLLING INTEREST		26,975	6,312
Income tax provision	15	14,020	5,869
Non-controlling interest		-	(180)
NET INCOME FOR THE YEAR		\$ 12,955	\$ 623
Earnings per Share - Basic		\$ 0.12	\$ 0.01
Earnings per Share - Diluted		\$ 0.12	\$ 0.01
Weighted average number of shares outstanding - Basic		108,120,452	91,802,881
Weighted average number of shares outstanding - Diluted		110,564,767	91,802,881

The accompanying notes are an integral part of these audited consolidated financial statements

FORTUNA SILVER MINES INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31,
(Expressed in thousands of US Dollars)

	2010	2009
Net income for the year	\$ 12,955	\$ 623
Other comprehensive income		
Unrealized gain on available for sale long term investments, net of taxes	-	148
Transfer of unrealized loss to realized loss upon derecognition of available for sale long term investment, net of taxes	-	462
Transfer of unrealized loss to realized loss upon reduction of net investment, net of taxes	2,100	-
Unrealized gain on translation of functional currency to reporting currency	5,895	13,400
Other comprehensive income	7,994	14,010
Comprehensive income for the year	\$ 20,949	\$ 14,633

The accompanying notes are an integral part of these audited consolidated financial statements

FORTUNA SILVER MINES INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31,
(Expressed in thousands of US Dollars)

	Notes	2010	2009
OPERATING ACTIVITIES			
Net income for the year		\$ 12,955	\$ 623
Items not involving cash			
Depletion and depreciation		6,896	5,858
Accretion expense		185	150
Future income tax		3,080	794
Stock-based compensation (recovery) expense		(416)	2,707
Unrealized (gain) loss on commodity contracts		(2,922)	4,473
Non-controlling interest		-	(180)
Write-off of deferred exploration costs		443	1,081
Loss on disposal of equipment		27	101
Loss on disposal of investments		119	236
Loss on disposal of mineral property		100	-
Unrealized foreign exchange loss		1,726	67
		<u>22,193</u>	<u>15,910</u>
Changes in non-cash working capital items			
Accounts receivable and prepaid expenses		(4,908)	(5,073)
Inventories		(1,537)	(313)
Accounts payable and accrued liabilities		5,372	3,158
Due to related parties		(11)	4
Net cash provided by operating activities		<u>21,109</u>	<u>13,686</u>
INVESTING ACTIVITIES			
Costs relating to the acquisition of Continuum	3	-	(162)
Short term investments		(13,858)	(5,990)
Mineral property expenditures		(16,595)	(11,023)
(Payments) receipts of value added taxes on purchase of property, plant and equipment		(2,915)	2,897
Acquisition of property, plant and equipment		(19,816)	(3,098)
Deposits on long term assets		(4,290)	96
Proceeds on disposal of equipment		68	47
Acquisition of long term investments		-	(235)
Proceeds on disposal of long term investments		-	489
Proceeds on disposal of mineral property		13	-
Net cash used in investing activities		<u>(57,393)</u>	<u>(16,979)</u>
FINANCING ACTIVITIES			
Net proceeds on issuance of common shares		74,922	1,025
Repayment of capital lease obligations		(1,231)	(976)
Net cash provided by financing activities		<u>73,691</u>	<u>49</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS		37,407	(3,244)
Effect of exchange rate changes on cash		2,128	4,553
Cash and cash equivalents - beginning of year		30,763	29,454
CASH AND CASH EQUIVALENTS - END OF YEAR		<u>\$ 70,298</u>	<u>\$ 30,763</u>

Supplemental cash flow information

21

The accompanying notes are an integral part of these audited consolidated financial statements

FORTUNA SILVER MINES INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Expressed in thousands of US Dollars, except for share amounts)

	<u>Share Capital</u>		Accumulated					Total Shareholders' Equity
	Shares	Amount	Contributed Surplus	Retained Earnings (Deficit)	Comprehensive Income (Loss) ("AOCT")	Other Total Retained Earnings (Deficit) and AOCI		
Balance - December 31, 2008	85,331,659	\$ 98,206	\$ 11,854	\$ (9,980)	\$ (11,112)	\$ (21,092)	\$ 88,968	
Exercise of options	389,000	281	-	-	-	-	281	
Exercise of warrants	2,475,355	776	-	-	-	-	776	
Issuance of shares for property	6,786,674	5,192	-	-	-	-	5,192	
Cancellation of fractional shares	(36)	-	-	-	-	-	-	
Transfer of contributed surplus on exercise of options	-	246	(246)	-	-	-	-	
Stock-based compensation	-	-	2,707	-	-	-	2,707	
Income for the year	-	-	-	623	-	623	623	
Unrealized gain on available for sale long term investments	-	-	-	-	148	148	148	
Transfer of unrealized loss to realized loss upon derecognition of available for sale long-term investment, net of taxes	-	-	-	-	462	462	462	
Unrealized gain on translation of functional currency to reporting currency	-	-	-	-	13,400	13,400	13,400	
Balance - December 31, 2009	94,982,652	\$ 104,701	\$ 14,315	\$ (9,357)	\$ 2,898	\$ (6,459)	112,557	
Issuance of shares under bought deal financing, net of issuance costs	26,507,500	73,919	-	-	-	-	73,919	
Exercise of options	999,500	1,004	-	-	-	-	1,004	
Issuance of shares for property	7,813	20	-	-	-	-	20	
Transfer of contributed surplus on exercise of options	-	759	(759)	-	-	-	-	
Stock-based compensation	-	-	(2,440)	-	-	-	(2,440)	
Income for the period	-	-	-	12,955	-	12,955	12,955	
Transfer of unrealized loss to realized loss upon reduction of net investment, net of taxes	-	-	-	-	2,100	2,100	2,100	
Unrealized gain on translation of functional currency to reporting currency	-	-	-	-	5,895	5,895	5,895	
Balance - December 31, 2010	122,497,465	\$ 180,403	\$ 11,116	\$ 3,597	\$ 10,892	\$ 14,489	\$ 206,008	

The accompanying notes are an integral part of these audited consolidated financial statements

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

1. Nature of Operations

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

2. Summary of Significant Accounting Policies

a) Basis of Presentation and Principles of Consolidation

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”), and presented in US dollars. The consolidated 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”); and Fortuna Silver Mines Peru S.A.C.

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

b) Change in Reporting Currency

Effective January 1, 2009, the Company changed its reporting currency to the US dollar. The change in reporting currency better reflects the Company’s business activities and improves investors’ ability to compare the Company’s financial results with other publicly traded businesses in the mining industry. Prior to January 1, 2009, the Company reported its annual and quarterly consolidated balance sheets and the related consolidated statements of operations and cash flows in Canadian dollars (CAD).

In making this change in reporting currency, the Company followed the recommendations of the Emerging Issues Committee (EIC) of the Canadian Institute of Chartered Accountants (“CICA”), set out in EIC-130, “Translation Method when the Reporting Currency Differs from the Measurement Currency or there is a Change in the Reporting Currency”.

In accordance with EIC-130, the financial statements for all years and periods presented have been translated into the new reporting currency using the current rate method. Under this method, the statements of operations and cash flows statements items for each year and period have been translated into the reporting currency using the average exchange rates prevailing during each reporting period. All assets and liabilities have been translated using the exchange rate prevailing at the consolidated balance sheets dates. All resulting exchange differences arising from the translation are included as a separate component of other comprehensive income. All comparative financial information has been restated to reflect the Company’s results as if they had been historically reported in US dollars.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

2. Summary of Significant Accounting Policies (continued)

c) Adoption of New Accounting Standards

The Company has not adopted any new accounting standards during the current year. The Company is adopting International Financial Reporting Standards (“IFRS”) effective January 1, 2011. Refer to Note 2 v).

d) Use of Estimates

The preparation of financial statements in conformity with Canadian GAAP requires the Company’s management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The most significant estimates are: quantities of proven and probable silver reserves; the value of mineralized material beyond proven and probable reserves; future costs and expenses to produce proven and probable reserves; future commodity prices and foreign currency exchange rates; the future cost of asset retirement obligations; amounts of contingencies; and the fair value of acquired assets and liabilities including pre-acquisition contingencies. Significant items that require estimates as the basis for determining the stated amounts include inventories, trade accounts receivable, mineral properties, property, plant and equipment, investments in non-producing properties, revenue recognition, stock-based compensation, unrealized gains and losses on commodity contracts, fair value of assets and liabilities acquired in a business combination, and taxes.

e) Revenue Recognition

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

f) Cash and Cash Equivalents

Cash and cash equivalents which are designated as held-for-trading financial assets and measured at fair value, include cash on hand and demand deposits.

g) Short term Investments

Short term investments, which are designated as held-for-trading financial assets and measured at fair value, include bank notes, guaranteed investment certificates, term deposits, and money market instruments with maturities, of 91 days to one year, from the date of acquisition.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

2. Summary of Significant Accounting Policies (continued)

h) Deposits on Long Term Assets

Deposits on long term assets consist of advance payments to construction contractors and equipment providers and other receivables which have a maturity period of greater than one year.

i) Property, Plant and Equipment

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

Buildings, mine site	Life of mine
Buildings, other	6 - 20 years
Machinery and equipment	3 - 8 years or Life of mine
Furniture and other equipment	3 - 13 years
Transport units	4 - 5 years

The expected remaining life of Caylloma mine as at December 31, 2010 is 9.3 years.

Land is not depreciated. Equipment under capital lease is initially recorded at the present value of minimum lease payments at the inception of the lease. Spare parts and components included in machinery and equipment, depending on the replacement period of the initial component, is depreciated over 8 to 18 months.

j) Depletion and Mineral Properties Cost

The Company defers the cost of acquiring, maintaining its interest, exploring, and developing mineral properties until such time as the properties are placed into production, abandoned, sold or considered to be impaired in value. General exploration costs that do not relate to a property where the Company has a vested interest are expensed as incurred. Costs of producing properties are depleted on a unit-of-production basis over proven and probable reserves and costs of abandoned properties are written-off. Proceeds received from the sale of interests in mineral properties are credited to the carrying value of the mineral properties, with any excess included in operations. Write-downs due to impairment in value are charged to operations.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

2. Summary of Significant Accounting Policies (continued)

j) Depletion and Mineral Properties Cost (continued)

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. If a mineable ore body is discovered, such costs are amortized when production commences. 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. In countries where the Company paid Value Added Tax ("VAT") and where there is uncertainty of its recoverability, the VAT payments are capitalized with mineral property costs relating to the property or expensed if the exploration costs have been expensed according to our accounting policy. If the Company recovers amounts that have been deferred, the amount received will be applied to reduce mineral property costs or taken as a credit against current expenses depending on the prior treatment.

k) Operational Mining Properties and Mine Development

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

Costs associated with commissioning activities on constructed plants are deferred from the date of mechanical completion of the facilities until the date the Company is ready to commence commercial production. Any revenues earned during this period are recorded as a reduction in deferred commissioning costs. These costs are depleted using the units-of-production method over the life of the mine, commencing on the date of commercial service.

l) Asset Impairment

Management reviews and evaluates its long-lived assets for impairment when events or changes in circumstances indicate that the related carrying amounts may not be recoverable. Impairment is considered to exist if total estimated future cash flows or probability-weighted cash flows on an undiscounted basis are less than the carrying amount of the assets, including mineral property, plant and equipment and producing and non-producing properties. An impairment loss is measured and recorded based on discounted estimated future cash flows or the application of an expected present value technique to estimate fair value in the absence of a market price. Future cash flows are based on recoverable proven and probable reserves and a portion of recoverable resources, silver, zinc, copper, lead and gold prices (considering current and historical prices, price trends and related factors), production levels, capital and reclamation costs, all based on detailed engineering life-of-mine plans. Assumptions underlying future cash flow estimates are subject to risks and uncertainties.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

2. Summary of Significant Accounting Policies (continued)

l) Asset Impairment (continued)

Any differences between significant assumptions and market conditions and/or the Company's performance could have a material effect on any impairment provision, and on the Company's financial position and results of operations. In estimating future cash flows, assets are grouped at the lowest levels for which there are identifiable cash flows that are largely independent of cash flows from other groups. Generally, in estimating future cash flows, all assets are grouped at a particular mine for which there is identifiable cash flow.

m) Asset Retirement Obligation

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

n) Inventories

Inventories include metals contained in concentrates, stockpile ores, materials, and supplies. The classification of metals inventory is determined by the stage at which the ore is in the production process. Inventories of ore 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. Mined material that does not contain a minimum quantity of metal to cover estimated processing expense to recover the contained metal is not classified as inventory and is assigned no value.

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.

o) Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to loss carryforwards and to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and loss carryforwards. Future tax assets and liabilities are measured using substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the year that includes the date of substantive enactment. Future tax assets are recognized to the extent that they are considered more likely than not to be realized.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

2. Summary of Significant Accounting Policies (continued)

p) Stock-based Compensation

i. Stock Option Plan

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

ii. Deferred Share Unit Plan (“DSU”)

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

iii. Restricted Share Unit Plan (“RSU”)

The Company recognizes a compensation cost in operating income on a prescribed vesting basis for each RSU granted equal to the 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 market value until the end of the performance date. The cumulative effect of the change in market value is recognized in operating income in the period of change.

q) Earnings (loss) per Share

Basic earnings (loss) per share is computed by dividing net income (loss) 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. The dilutive effect of outstanding options and warrants 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 CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

2. Summary of Significant Accounting Policies (continued)

r) Foreign Currency Translation

The Company's functional currency is the Canadian dollar. On January 1, 2009, the Company changed its reporting currency to the US dollar.

Transaction amounts denominated in foreign currencies are translated at exchange rates prevailing at the transaction dates. Carrying values of foreign currency monetary assets and liabilities are adjusted at each balance sheet date to reflect the exchange rate prevailing at that date. Gains and losses arising from translation of foreign currency monetary assets and liabilities at each period end are included in earnings.

The accounts of certain subsidiaries, which are considered to be integrated operations, are translated into US dollars using the temporal method. Under this method, monetary assets and liabilities of foreign subsidiaries are translated at exchange rates in effect at the end of each period and non-monetary assets and liabilities are translated using historical exchange rates. Revenues and expenses are translated at the average exchange rate for the period. Foreign currency transaction gains and losses are included in the determination of net income or loss.

The accounts of other subsidiaries are translated using the current rate method. Assets and liabilities are translated into US dollars using the current rate method at period-end exchange rates and resulting translation adjustments are reflected in comprehensive income. Revenues and expenses are translated at average exchange rates for the period.

s) Financial Instruments

All financial liabilities must be classified as held-for-trading or other financial liabilities. All financial instruments, including derivatives, are included on the Consolidated Balance Sheets and are measured at fair value, except for held-to-maturity investments, loans and receivables, and other financial liabilities, and these are all measured at amortized cost. The carrying value of receivables, and accounts payable and accrued liabilities approximate their fair value because of the short-term maturity of those instruments. Subsequent measurements and recognition of changes in fair value depend on the instrument's initial classification. Held-for-trading financial instruments are measured at fair value, and all gains and losses are included in net income (loss) in the period in which they arise. 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 balance sheet. 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. Also, transaction costs related to all financial assets and liabilities are recorded in the acquisition or issue cost, unless the financial instrument is classified as held-for-trading or other liabilities, in which case the transaction costs are recognized immediately in net income (loss).

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

2. Summary of Significant Accounting Policies (continued)

s) Financial Instruments (continued)

Financial and non-financial derivative instruments are measured at fair value and recorded as either assets or liabilities. Certain derivatives embedded in non-derivative contracts must also be measured at fair value. Any changes in the fair value of recognized derivatives are included in net income (loss) for the period in which they arise, unless specific hedge accounting criteria are met, as defined in CICA Section 3865. The same accounting treatment applied to these non-financial derivative contracts prior to the adoption of CICA Section 3855. Fair values for the Company's recognized commodity-based derivatives are based on the forward prices of the associated market index.

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	Held-for-trading	Fair value
Short Term Investments	Held-for-trading	Fair value
Accounts Receivable	Loans and receivables	Amortized cost
Long Term Receivables	Loans and receivables	Amortized cost
Derivatives	Held-for-trading	Fair value
Accounts Payable and Accrued Liabilities	Other liabilities	Amortized cost
Due to Related Parties	Other liabilities	Amortized cost
Long Term Liability	Other liabilities	Amortized cost

t) Derivatives and Trading Activities

The Company employs metals contracts, including forward contracts to manage exposure to fluctuations in metal prices. For metals production, these contracts are intended to reduce the risk of falling prices on the Company's future sales.

All derivative instruments are recorded on the balance sheet at fair value. Unrealized gains and losses on derivative instruments are marked to market at the end of each accounting period with the results included in gain or loss on commodity and foreign currency contracts in the Consolidated Statement of Operations.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

2. Summary of Significant Accounting Policies (continued)

u) Comparative figures

Certain comparative figures have been reclassified to conform with the presentation adopted for the current year. In particular, Long Term Investments and Receivables are now included in Deposits on Long Term Assets.

v) Recently released Canadian Accounting Standards

The Company has assessed new and revised accounting pronouncements that have been issued and determined that the following will have an impact on the Company:

Convergence with International Financial Reporting Standards (“IFRS”)

In 2006, the Canadian Accounting Standards Board (“AcSB”) published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian GAAP with International Financial Reporting Standards (“IFRS”) over an expected five year transitional period. In February 2008, the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canadian GAAP. This date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The Company will begin reporting its financial statements in accordance with IFRS on January 1, 2011, with comparative figures for 2010.

The adoption date of January 1, 2011 will require the restatement, for comparative purposes, of amounts reported by the Company for its year ended December 31, 2010, and of the opening balance sheet as at January 1, 2010.

3. Acquisition of mining interest

On March 6, 2009, the Company closed the acquisition of all the issued and outstanding shares of Continuum which had 124,037,920 shares outstanding as of March 6, 2009. The Company agreed to issue to the Continuum shareholders a total of 6,995,738 shares, which is an exchange ratio of approximately 0.0564 of a share of the Company for every one Continuum share held.

As Fortuna held 3,706,250 common shares of the issued and outstanding share capital of Continuum as at March 6, 2009, those shares were cancelled and Fortuna issued a total of 6,786,674 shares to the Continuum shareholders other than Fortuna. As a result of the acquisition of Continuum, Fortuna now owns 100% of the San Jose Project in Oaxaca, Mexico.

The acquisition is being accounted for as a purchase of assets. The following calculations include the fair value of Fortuna shares issued, based on the issuance of 6,786,674 Fortuna shares at CAD\$0.98 per share for consideration of \$5,194 (CAD\$6,651). A valuation date of March 6, 2009 was determined for the share value.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

3. Acquisition of mining interest (continued)

The difference between the purchase consideration and the fair values of Continuum's other assets and liabilities has been allocated to "Mineral properties". The fair value of all identifiable assets and liabilities acquired was determined by a valuation effective March 6, 2009. No future tax asset has been recorded. The resulting "negative" purchase price discrepancy would have resulted in a future tax asset as it is more likely than not that this will not be recovered.

The purchase price allocation is as follows:

Purchase price		
6,786,674 common shares of Fortuna	\$	5,194
Acquisition costs		113
Loan to Continuum		3,184
Cost of shares previously acquired		130
Total purchase price	\$	8,621

Purchase price allocation		
Net assets acquired:		
Cash received	\$	5
Property, plant & equipment		6
Mineral property interests		8,749
Accounts payable and accrued liabilities		(139)
Net identifiable assets of Continuum	\$	8,621

Included as part of the mineral property interests purchased was the Predilecta project in Mexico with a value of \$87 at acquisition date.

As a result of the acquisition of Continuum, the non-controlling interest previously in Cuzcatlan was eliminated.

4. Short Term Investments

Held-for-Trading	December 31, 2010		December 31, 2009	
	Fair Value	Cost	Fair Value	Cost
Short term investments	\$20,509	\$20,509	\$ 6,034	\$ 6,034
	\$20,509	\$20,509	\$ 6,034	\$ 6,034

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

5. Derivatives

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.

The forward sale and option contracts are settled against the arithmetic average of metal spot prices over the month in which the contract matures.

The contracts are spread evenly over the periods shown below with settlement occurring on a monthly basis. No initial premium associated with these trades has been paid.

As at December 31, 2010, the Company had the following contracts outstanding:

<i>Type of contract</i>	<i>Metal</i>	<i>Total tonnage (t) or ounces (oz)</i>	<i>Settlement period</i>	<i>Price/t or Price/oz</i>
<i>Forward sale</i>	<i>Lead</i>	<i>210 t</i>	<i>March 2011</i>	<i>\$2,500/t</i>
<i>Forward sale</i>	<i>Zinc</i>	<i>240 t</i>	<i>March 2011</i>	<i>\$2,415/t</i>
<i>Long put</i>	<i>Silver</i>	<i>90,000 oz</i>	<i>January 2011</i>	<i>\$28.00/oz</i>
<i>Short call</i>	<i>Silver</i>	<i>90,000 oz</i>	<i>January 2011</i>	<i>\$32.10/oz</i>
<i>Long put</i>	<i>Silver</i>	<i>50,000 oz</i>	<i>January 2011</i>	<i>\$29.00/oz</i>
<i>Short call</i>	<i>Silver</i>	<i>50,000 oz</i>	<i>January 2011</i>	<i>\$31.70/oz</i>

As at December 31, 2009 the main contracts outstanding were the following:

<i>Type of contract</i>	<i>Metal</i>	<i>Total tonnage (t)</i>	<i>Settlement period</i>	<i>Price/t</i>
<i>Forward sale</i>	<i>Lead</i>	<i>1,800</i>	<i>Jan 2010 – Jun 2010</i>	<i>US\$1,910/t</i>
<i>Forward sale</i>	<i>Zinc</i>	<i>1,050</i>	<i>Jan 2010 – Jun 2010</i>	<i>US\$1,787/t</i>
<i>Long put</i>	<i>Zinc</i>	<i>2,100</i>	<i>Jan 2010 – Jun 2010</i>	<i>US\$2,000/t</i>
<i>Short call</i>	<i>Zinc</i>	<i>2,100</i>	<i>Jan 2010 – Jun 2010</i>	<i>US\$3,010/t</i>
<i>Long put</i>	<i>Lead</i>	<i>1,200</i>	<i>Jan 2010 – Jun 2010</i>	<i>US\$2,000/t</i>
<i>Short call</i>	<i>Lead</i>	<i>1,200</i>	<i>Jan 2010 – Jun 2010</i>	<i>US\$2,975/t</i>
<i>Long put</i>	<i>Zinc</i>	<i>3,150</i>	<i>Jul 2010 – Dec 2010</i>	<i>US\$2,000/t</i>
<i>Short call</i>	<i>Zinc</i>	<i>3,150</i>	<i>Jul 2010 – Dec 2010</i>	<i>US\$3,010/t</i>
<i>Long put</i>	<i>Lead</i>	<i>2,850</i>	<i>Jul 2010 – Dec 2010</i>	<i>US\$2,000/t</i>
<i>Short call</i>	<i>Lead</i>	<i>2,850</i>	<i>Jul 2010 – Dec 2010</i>	<i>US\$2,974/t</i>

The estimated fair value of the outstanding liability in derivative contracts of \$133 (2009: liability \$3,055) was determined with reference to the published market prices for underlying commodities quoted at the London Metal Exchange.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

6. Accounts Receivable and Prepaid Expenses

	December 31, 2010	December 31, 2009
Trade accounts receivable	\$ 11,224	\$ 7,154
Advances and other receivables	1,327	1,168
Prepaid expenses and deposits	903	313
	\$ 13,454	\$ 8,635

Accounts receivable and prepaid expenses include prepaid income tax of \$nil (2009: \$9), \$39 (2009: \$121) short term portion of the long term receivable, \$57 (2009: \$34) in guarantee deposits. Trade accounts receivable includes receivables from the sale of concentrates of \$11,224 (2009: \$7,154) and are aged as follows:

	December 31, 2010	December 31, 2009
0-30 days	\$ 9,754	\$ 7,154
31-60 days	1,057	-
61-90 days	413	-
over 90 days	-	-
	\$ 11,224	\$ 7,154

The Company has no allowance for doubtful accounts (2009: \$nil).

7. Inventories

Inventories consist of the following:

	December 31, 2010	December 31, 2009
Stockpile ore	\$ 1,274	\$ 204
Concentrate inventory	347	651
Materials and supplies	2,413	1,474
	\$ 4,034	\$ 2,329

The amount of inventory recognized as expenses during 2010 was \$22,270 (2009: \$17,755) and there has been no impairment during 2010 (2009: \$nil).

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

8. Deposits on Long Term Assets

Deposits on long term assets consist of advance payments to construction contractors and equipment providers, and other receivables that are long term in nature and consist of the following:

	December 31, 2010		December 31, 2009	
Deposits on equipment	\$	2,996	\$	-
Deposits to contractors		1,529		-
Other		8		16
	\$	4,533	\$	16

9. Property, Plant and Equipment

Property, plant and equipment are comprised of the following:

	December 31, 2010			December 31, 2009		
	Accumulated Net Book			Accumulated Net Book		
	Cost	Depreciation	Value	Cost	Depreciation	Value
Land	\$ 329	\$ -	\$ 329	\$ 316	\$ -	\$ 316
Buildings	8,760	2,069	6,691	4,740	1,040	3,700
Machinery & equipment	11,451	4,027	7,424	10,152	3,023	7,129
Equipment under capital lease	4,174	1,281	2,893	3,249	568	2,681
Furniture & other equipment	4,174	836	3,338	1,627	438	1,189
Transport units	442	331	111	430	239	191
Work in progress	14,977	-	14,977	2,027	-	2,027
	\$44,307	\$ 8,544	\$ 35,763	\$ 22,541	\$ 5,308	\$ 17,233

Machinery & equipment includes costs of \$682 (2009: \$526) and accumulated depreciation of \$201 (2009: \$131) resulting from the estimate for the asset retirement obligation.

Work in progress includes construction costs of \$1,029 (2009: \$1,202) and \$13,948 (2009: \$825) related to the Caylloma, Peru and San Jose, Mexico properties, respectively.

The net carrying amount of \$2,503 (2009: \$2,503) related to an idle plant in Mexico, is not being amortized while the San Jose, Mexico property is under construction.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

10. Mineral Properties

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

	December 31, 2010				December 31, 2009			
	Cost	Depletion	Write-off	Net Book Value	Cost	Depletion	Write-off	Net Book Value
Caylloma, Peru	\$ 51,971	\$ 16,079	\$ 443	\$ 35,449	\$ 42,209	\$ 11,685	\$ 160	\$ 30,364
San Jose, Mexico	55,525	-	-	55,525	44,745	-	1,091	43,654
Tlacolula, Mexico	76	-	-	76	-	-	-	-
Predilecta, Mexico	118	-	118	-	109	-	-	109
	\$107,690	\$16,079	\$ 561	\$91,050	\$ 87,063	\$ 11,685	\$ 1,251	\$ 74,127

a) Caylloma Project, Peru

For the year ended December 31, 2010, additions to the Caylloma mineral property includes development and exploration costs of \$9,564 (2009: \$6,122).

During the year ended December 31, 2010, the Company wrote down exploration costs in the amount of \$443 (2009: \$160) as it was determined there are significant exploration risks and does not warrant drill testing of the property.

b) San Jose Project, Mexico

For the year ended December 31, 2010, additions to the San Jose mineral property consist of development and exploration costs capitalized of \$5,781 (2009: \$5,742), general and administrative costs to develop the mine of \$2,308 (2009: \$1,425), and asset retirement obligation of \$1,626 (2009: \$nil).

Included in the additions for the San Jose property is \$62 (2009: \$66) relating to the accretion of the payable for the Monte Alban II concession. This property was acquired for a total of \$1,900 and consists of a payment of \$1,100 made in May 2008 and a future payment of \$800 to be made in May 2012 (Note 13. b)). The present value of the \$800 was \$589 and this is being accreted monthly with the accretion amount being capitalized to the mineral property.

Also included in the additions for the San Jose mineral property is depreciation of equipment involved in construction work of \$317 (2009: \$220) and \$1 (2009: \$141) received as interest on VAT recovered.

c) Tlacolula Project, Mexico

In September 2009, the Company, through its wholly owned subsidiary, Cuzcatlan, was granted an option (the "Option") to acquire a 60% interest (the "Interest") in the Tlacolula silver project ("property") located in the State of Oaxaca, Mexico from Radius Gold Inc.'s wholly owned subsidiary, Radius (Cayman) Inc. ("Radius") (a related party by way of directors in common with the Company).

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

10. Mineral Properties (continued)

c) Tlacolula Project, Mexico (continued)

The Company can earn the Interest by spending \$2,000, which includes a commitment to drill 1,500 meters within three years, and making staged annual payments of \$250 cash and \$250 in common stock of the Company to Radius according to the following schedule:

- \$20 cash and \$20 cash equivalent in shares upon stock exchange approval;
- \$30 cash and \$30 cash equivalent in shares by the first year anniversary;
- \$50 cash and \$50 cash equivalent in shares by the second year anniversary;
- \$50 cash and \$50 cash equivalent in shares by the third year anniversary; and,
- \$100 cash and \$100 cash equivalent in shares by the fourth year anniversary.

Upon completion of the cash payments and share issuances, and incurring the exploration expenditures as set forth above, the Company will be deemed to have exercised the Option and acquired a 60% interest in the property, whereupon a joint venture will be formed to further develop the property on the basis of the Company owning 60% and Radius 40%.

On January 15, 2010, the transaction was approved by the TSX Venture Exchange. The Company has issued 7,813 common shares of the Company, at a fair market value of \$2.56 per share and paid \$20 cash according to the terms of the option agreement. Refer to Note 22.

d) Predilecta, Mexico

During the first quarter of 2010, the Company sold its interest in the Predilecta mineral property, for cash consideration of \$13 resulting in a loss of \$100.

11. Accounts Payable and Accrued Liabilities

	December 31, 2010	December 31, 2009
Trade accounts payable	\$ 3,968	\$ 2,577
Income taxes payable	4,192	2,949
Payroll and other payables	5,249	2,557
Restricted share unit payable	87	-
	\$ 13,496	\$ 8,083

Payroll and other payables includes \$2,328 (2009: \$1,084) attributable to workers' participation under Peruvian law and \$495 (2009: \$nil) attributable to bonus accruals.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

12. Related Party Transactions

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

Transactions with related parties	Years ended December 31,	
	2010	2009
Consulting fees ¹	\$ 175	\$ 145
Salaries and wages ^{2,3}	174	122
Other general and administrative expenses ³	185	159
	<u>\$ 534</u>	<u>\$ 426</u>

¹ Consulting fees includes fees paid to two directors, Simon Ridgway and Mario Sztolender.

² 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.

^{2,3} Radius Gold Inc. ("Radius") has directors in common with the Company and shares office space, and is reimbursed for various general and administrative costs incurred on behalf of the Company.

In September 2009, the Company was granted an option to acquire a 60% interest in the Tlacolula silver project located in the State of Oaxaca, Mexico from Radius. Refer to Notes 10. c) and 22.

Amounts due to/(from) related parties	December 31, 2010		December 31, 2009	
Owing (from)/to a director and officer ⁴	\$	(1)	\$	(1)
Owing to a company with common directors ³	\$	41	\$	50
	<u>\$</u>	<u>40</u>	<u>\$</u>	<u>49</u>

⁴ Owing from a director includes non-interest bearing advances to Jorge A. Ganoza Durant at December 31, 2010 and 2009.

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.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

13. Leases and Long Term Liabilities

Leases and long term liabilities are comprised of the following:

	December 31, 2010	December 31, 2009
Obligations under capital Lease	\$ 462	\$ 810
Long term liability	705	644
Deferred share unit payable	1,955	-
Restricted share unit payable	44	-
	\$ 3,166	\$ 1,454

a) Obligations under Capital Lease

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

	Interest Rate	Maturity Date	December 31, 2010	December 31, 2009
Gross lease payments:				
Scotia Bank Peru S.A.A.	8.66%	2010	-	104
Scotia Bank Peru S.A.A.	8.20%	2010	-	261
Scotia Bank Peru S.A.A.	8.49%	2010	-	60
Scotia Bank Peru S.A.A.	8.34%	2011	1	15
Scotia Bank Peru S.A.A.	8.49%	2011	31	107
Scotia Bank Peru S.A.A.	6.75%	2011	7	17
Scotia Bank Peru S.A.A.	6.75%	2011	9	22
Banco Internacional del Peru S.A.A.	4.00%	2011	93	205
Banco Internacional del Peru S.A.A.	9.12%	2011	89	185
Banco Internacional del Peru S.A.A.	9.75%	2012	58	101
Scotia Bank Peru S.A.A.	4.50%	2012	341	-
Banco Internacional del Peru S.A.A.	9.75%	2012	574	936
Scotia Bank Peru S.A.A.	4.50%	2012	360	-
Scotia Bank Peru S.A.A.	4.85%	2012	58	-
Gross lease payments			\$ 1,622	\$ 2,014
Less: interest			(77)	(165)
Total payment, net of interest			\$ 1,545	\$ 1,848
Less: current amount			(1,083)	(1,038)
			\$ 462	\$ 810

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

13. Leases and Long Term Liabilities (continued)

b) Long Term Liability

In May 2008, the Company acquired the Monte Alban II concession (10. b)) for which a payment of \$800 is due May 2012. This payment is non-interest bearing and all debt relating to the acquisition of the mineral resource property has been recognized as at December 31, 2010.

	December 31,	December 31,
	2010	2009
Face value of long term liability	\$ 644	\$ 970
Less: adjustment to amortized cost	-	(225)
Opening fair value of liability measured at amortized cost	644	745
Cancellation of contract	-	(156)
Add: accretion to period end	61	55
Liability at period end	705	644
Less: current portion of long term liability	-	-
	\$ 705	\$ 644

Principal minimum repayment terms will be :

2011	\$	-
2012		800
	\$	800

c) Contingent Liabilities

The Caylloma mine closure plan was approved in November 2009 with total closure costs of \$3,587 of which \$1,756 is subject to an annual collateral in the form of a letter of guarantee, to be awarded each year in increments of \$146 over 12 years, and is 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 expire 360 days from June 2010.

Interbank, a third party, has renewed the bank letter of guarantee in the amount of \$2, in favor of the Peruvian Ministry of Energy and Mines, to allow a temporary concession to study electric power generation in the hydro electric power plant, to expire April 2011.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

13. Leases and Long Term Liabilities (continued)

d) Deferred Share Units Payable

The deferred share units are recorded on the balance sheet at fair value. As at December 31, 2010, there are 409,097 (2009: nil) deferred share units outstanding with a mark-to-market value of \$1,955 (2009: \$nil).

e) Restricted Share Units Payable

The restricted share units are recorded on the balance sheet at fair value. As at December 31, 2010, there are 219,114 (2009: nil) restricted share units outstanding with a mark-to-market value of \$131 (2009: \$nil) of which \$87 is current (2009: \$nil). Refer to Note 11.

14. Asset Retirement Obligation

A summary of the Company's provision for asset retirement obligation ("ARO") is presented below.

	December 31, 2010	December 31, 2009
Asset retirement obligation - beginning of year	\$ 2,529	\$ 1,066
Additions to obligation	1,626	-
Revisions in estimates	584	1,286
Accretion expense, included in depreciation, depletion and accretion	185	150
Foreign exchange impact	-	27
Asset retirement obligation - end of year	\$ 4,924	\$ 2,529

For the Caylloma Mine, the accretion expense of \$185 (2009: \$150) was calculated over the year using a risk free interest rate of 4.87% (2009: 7.46%). The Company had reviewed its reclamation obligations at the property in light of changing regulations and on the basis of further data in respect of the mine life and had made an increase to the estimated amount of the asset retirement obligation of \$584 (2009: \$1,286) with a foreign exchange impact of \$ nil (2009: \$27). As at December 31, 2010, the accrued obligation was estimated using an undiscounted cash flow of \$3,587 (2009: \$3,346), a risk free rate of 4.87% (2009: 7.46%), mine life of 8.17 years (2009: 9.67 years), and Nuevo Soles to United States dollars foreign exchange rate of 2.809 (2009: 3.011). The accrued obligation at December 31, 2010 is \$3,298. Refer to Note 13 c).

For the San Jose mine development, the Company estimated the ARO using a undiscounted cash flow of \$2,540 (2009: \$nil), a risk free rate interest rate of 4.945% (2009: nil), a mine life of 9 years, and Mexican Pesos to United States dollars foreign exchange rate of 12.610 (2009: nil). Accretion expense over the year is \$nil (2009: \$nil) and the accrued obligation at December 31, 2010 is \$1,626 (2009: \$nil).

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

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

14. Asset Retirement Obligation (continued)

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

15. Income Tax

- a) Income tax expense differs from the amount that would be computed by applying the Canadian statutory income tax rate of 29% (2009 - 30%) to income before income taxes and non-controlling interest. The reasons for the differences are as follows:

	December 31,	December 31,
	2010	2009
Income before income taxes and non-controlling interest	\$ 26,975	\$ 6,312
Statutory income tax rate	29%	30%
Expected income tax	\$ 7,688	\$ 1,894
Items (deductible) non-deductible for income tax purposes	(488)	948
Difference between Canadian and foreign tax rates	2,535	1,130
Change in income tax rates	431	346
Change in exchange rates	24	818
Change in valuation allowance	3,830	733
Total income taxes	\$ 14,020	\$ 5,869
Represented by:		
Current income tax	\$ 10,940	\$ 5,075
Future income tax	3,080	794
	\$ 14,020	\$ 5,869

Current income taxes payable of \$4,192 (2009: \$2,949) is included within accounts payable and accrued liabilities in Note 11.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

15. Income Tax (continued)

- b) The tax effects items that give rise to significant portions of the future tax assets and future tax liabilities at December 31, 2010 and 2009 are presented below:

	December 31, 2010	December 31, 2009
Future income tax assets:		
Non-capital losses	\$ 10,500	\$ 5,416
Share issue costs	1,037	275
Asset retirement obligation and other	2,185	207
Financial derivatives	48	1,125
Mineral properties and property, plant and equipment	1,012	927
Total future income tax assets	14,782	7,950
Valuation allowance	(10,553)	(6,599)
Net future income tax assets	4,229	1,351
Future income tax liabilities:		
Mineral properties – Peru	\$ (13,360)	\$ (10,366)
Mineral properties – Mexico	(5,024)	(1,958)
Equipment	(178)	-
Total future income tax liabilities	\$ (18,562)	\$ (12,324)
Net future income tax liabilities	\$ (14,333)	\$ (10,973)

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

15. Income Tax (continued)

- c) The Company has non-capital loss carry-forwards that will expire if unused of \$40,248 that may be available for tax purposes. The loss carry-forwards expire as follows:

	Canada	Peru	Mexico
Non-capital losses, expiring as follows:			
2013	\$ 380	\$ -	\$ -
2014	1,129	-	-
2016	915	-	41
2017	-	-	3,371
2025	2,139	-	1,999
2026	2,342	-	-
2027	3,850	-	-
2028	1,597	-	-
2029	4,674	-	3,702
2030	9,876	-	3,876
No expiry	-	357	-
	\$ 26,902	\$ 357	\$ 12,989

A full valuation allowance has been recorded against the potential future income tax assets associated with the Canadian loss carry-forwards as their utilization is not considered more likely than not at this time.

16. Share Capital

- a) Authorized: Unlimited common shares without par value

On June 17, 2009, an aggregate of 36 common shares resulting from rounding of previous capital consolidations were returned to treasury to reduce the accumulated fractional shares held in the Company's trustee account.

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.

Subsequent to December 31, 2010 to March 23, 2011, the Company issued 6,756 common shares, at a fair market value of CAD\$4.41 per share, to Radius (refer to Notes 10.c) and 22) and 245,000 share purchase options were exercised at prices ranging from CAD\$0.83 to CAD\$2.22 per share, resulting in issued and outstanding shares of 122,749,221.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

16. Share Capital (continued)

b) Stock 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 the length of the grant expiring up to ten years from grant.

The following is a summary of option transactions:

	Number of Shares	Weighted Average Exercise Price Per Share in CAD\$
Balance, December 31, 2008	7,734,000	\$ 1.87
Granted	2,915,000	1.56
Exercised	(389,000)	0.81
Expired	(970,000)	2.35
Forfeited	(1,075,000)	3.22
Balance, December 31, 2009	8,215,000	\$ 1.50
Exercised	(999,500)	1.03
Cancelled	(2,665,000)	1.62
Balance, December 31, 2010	4,550,500	\$ 1.51

During the period, 999,500 share purchase options with exercise prices ranging from CAD\$0.80 to CAD\$2.29 per share were exercised.

During the period, 2,665,000 share purchase options with exercise prices ranging from CAD\$1.60 to CAD\$2.23 were cancelled as shareholder approval was not obtained at the Company's annual general meeting held on June 23, 2010.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

16. Share Capital (continued)

b) Stock options (continued)

The following table summarizes information related to stock options outstanding and exercisable at December 31, 2010:

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\$	Vested share purchase options (in 000's)	Weighted average exercise price on vested share purchase options CAD\$
\$0.80 to \$0.99	1,621	7.7	\$ 0.85	1,621	\$ 0.85
\$1.00 to \$1.99	1,800	5.5	1.61	1,800	1.61
\$2.00 to \$2.75	1,130	6.1	2.30	1,130	2.30
\$0.80 to \$2.75	4,551	6.4	\$ 1.51	4,551	\$ 1.51

The weighted average remaining life of vested share purchase options at December 31, 2010 was 6.4 years (2009: 8.3 years).

As at December 31, 2010, 4,550,500 share purchase options have vested.

Subsequent to December 31, 2010 to March 23, 2011, 245,000 share purchase options were exercised at prices ranging from CAD\$0.83 to CAD\$2.22 per share.

c) Stock-based Compensation

i. Stock Option Plan

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

The non-cash compensation charge of \$2,707 recognized for the year ended December 31, 2009 is associated with options granted to a directors, officers, and employees. These compensation charges have been determined under the fair value method using the Black-Scholes option pricing model with the following assumptions:

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

16. Share Capital (continued)

c) Stock-based compensation (continued)

i. *Stock option plan (continued)*

	Years ended December 31,	
	2010	2009
Risk-free interest rate	n/a	2.42% to 3.45%
Expected stock price volatility	n/a	70% to 78%
Expected term in years	n/a	5 to 10 years
Expected dividend yield	n/a	0%

The weighted average grant date fair value of options granted during the year ended December 31, 2010 was CAD\$nil (2009 - CAD\$0.91).

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.

ii. *Deferred Share Units Cost*

During the year, the Company implemented a deferred share unit 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. As at December 31, 2010, there are 409,097 (2009: nil) deferred share units outstanding with a mark-to-market cost of \$1,897 (2009: \$nil).

iii. *Restricted Share Units Cost*

During the year, the Company implemented a restricted share unit plan for certain employees or officers. The RSUs entitle employees or officers to a cash payment after the end of each 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 RSUs held by the employee.

As at December 31, 2010, there are 219,114 (2009: nil) restricted share units outstanding with a mark-to-market cost of \$127 (2009: \$nil).

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

16. Share Capital (continued)

d) Reserves

During the year, the Board of Directors of Bateas has appropriated reserves of \$975 (2009: \$1,130) from its retained earnings representing ten percent of the net income earned in the calendar years 2009 (2009: 2006, 2007, and 2008). The reserve is required under the Republic of Peru's General Corporate Law (Ley General de Sociedades) article 229, whereas a legal reserve equivalent to a minimum of ten percent of the distributable value of each financial year, net of income taxes until the reserve reaches an amount equal to one fifth of its capital (capital defined as share capital and retained earnings) must be established. The excess over this limit is not a legal reserve. Dividends can only be paid on profits free of reserves.

e) Weighted average number of common shares and dilutive common share equivalents

	December 31, 2010	December 31, 2009
Weighted average number of commons shares	108,120	91,803
Weighted average number of dilutive stock options	2,445	-
	110,565	91,803

17. Segmented Information

a) Industry Information

The Company operates in one reportable operating segment, being the acquisition, exploration, development, and operation of mineral properties.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

17. Segmented Information (continued)

b) Geographic Information

The following is the summary of operations and summary of certain assets on a geographical basis.

	Canada	Peru	Mexico	Other	Total
Year ended December 31, 2010					
Sales	\$ -	\$ 74,056	\$ -	\$ -	\$ 74,056
Operating income (loss)	\$ (5,807)	\$ 35,962	\$ -	\$ (44)	\$ 30,111
Year ended December 31, 2009					
Sales	\$ -	\$ 51,428	\$ -	\$ -	\$ 51,428
Operating income (loss)	\$ (5,612)	\$ 20,992	\$ (921)	\$ (76)	\$ 14,383
As at December 31, 2010					
Mineral Properties	\$ -	\$ 35,449	\$ 55,601	\$ -	\$ 91,050
Property, plant and equipment	\$ 6	\$ 14,953	\$ 20,804	\$ -	\$ 35,763
Total assets	\$ 81,439	\$ 77,760	\$ 83,973	\$ 11	\$ 243,183
As at December 31, 2009					
Mineral Properties	\$ -	\$ 30,364	\$ 43,763	\$ -	\$ 74,127
Property, plant and equipment	\$ 11	\$ 12,298	\$ 4,922	\$ 2	\$ 17,233
Total assets	\$ 25,120	\$ 67,978	\$ 46,614	\$ 26	\$ 139,738

c) Major Customers

For the year ended December 31, 2010, there were two customers accounting for 64% and 36%, respectively, of the total sales of the Company.

For the year ended December 31, 2009, there was one customer accounting for 94% of total sales of the Company.

18. Commitments and Contingencies

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.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

18. Commitments and Contingencies (continued)

The Company acts as guarantor to capital lease obligations held by two of its mining contractors. These capital lease contracts are related to the acquisition of mining equipment deployed at the Caylloma mine. As at December 31, 2010, these obligations amounted to \$711 with \$231 and \$480 maturing in 2011 and 2012, respectively.

a) Environmental Matters

The Company's mining and exploration activities are subject to various laws and regulations governing the protection of the environment. These laws and regulations are continually changing and are generally becoming more restrictive. The Company conducts its operations so as to protect the public health and environment and believes its operations are in compliance with applicable laws and regulations in all material respects. The Company has made, and expects to make in the future, expenditures to comply with such laws and regulations, but cannot predict the full amount of such future expenditures.

Estimated future reclamation costs are based principally on legal and regulatory requirements. As of December 31, 2010, \$4,924 (2009: \$2,529) was accrued for reclamation costs relating to mineral properties in accordance with Section 3110, "Asset Retirement Obligations". See Note 14.

b) Income Taxes

The Company operates in numerous countries around the world and accordingly it is subject to, and pays annual income taxes under the various income tax regimes in the countries in which it operates. Some of these tax regimes are defined by contractual agreements with the local government, and others are defined by the general corporate income tax laws of the country.

The Company has historically filed, and continues to file, all required income tax returns and to pay the taxes reasonably determined to be due. The tax rules and regulations in many countries are highly complex and subject to interpretation. From time to time, the Company is subject to a review of its historic income tax filings and in connection with such reviews, disputes can arise with the taxing authorities over the interpretation or application of certain rules to the Company's business conducted within the country involved.

c) Title Risk

Although the Company has taken steps to verify title to properties in which it has an interest, these procedures do not guarantee the Company's title. Property title may be subject to, among other things, unregistered prior agreements or transfers and may be affected by undetected defects.

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

18. Commitments and Contingencies (continued)

d) Credit Facility

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. The interest margin on drawings under the facility ranges from 4% to 4.5% depending on the leverage ratio. A stand-by fee between 1.25% and 1.5% depending on the leverage ratio is to be paid on the undrawn amounts under the facility. No funds were drawn from this credit facility during the year.

19. 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 shareholders’ 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 December 31, 2010, 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 year.

20. 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, accounts payable and accrued liabilities, and due to related parties approximate their fair value due to the relatively short periods to maturity and the terms of these financial instruments.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

20. Management of Financial Risk (continued)

a) Fair Value of Financial Instruments (continued)

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.

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.

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

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

Financial assets (liabilities) at fair value as at December 31, 2009				
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 30,763	\$ -	\$ -	\$ 30,763
Short term investments	6,034	-	-	6,034
Accounts receivable	-	8,322	-	8,322
Derivatives	-	(3,055)	-	(3,055)
	\$ 36,797	\$ 5,267	\$ -	\$ 42,064

FORTUNA SILVER MINES INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

20. Management of Financial Risk (continued)

a) Fair Value of Financial Instruments (continued)

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 year ended December 31, 2010, there have been no changes in the classification of financial assets and liabilities in level 3 of the hierarchy.

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, Mexico and Barbados 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 results of operations, financial position, or cash flows. The Company has not hedged its exposure to currency fluctuations.

As at December 31, 2010, 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):

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

20. Management of Financial Risk (continued)

b) Currency Risk (continued)

	December 31, 2010			December 31, 2009		
	Canadian Dollars	Nuevo Soles	Mexican Pesos	Canadian Dollars	Nuevo Soles	Mexican Pesos
Cash and cash equivalents	\$ 54,782	S/. 741	\$ 2,201	\$ 21,283	S/. 302	\$ 1,283
Short term investments	20,514	-	-	560	-	-
Accounts receivable	71	1,304	42,452	5	880	6,565
Long term investment and receivable	-	-	24,209	-	-	-
Accounts payable and accrued liabilities	(625)	(27,268)	(6,390)	(194)	(17,150)	(623)
Long term liability	(1,999)	-	-	-	-	-
Asset retirement obligation	-	(9,169)	(19,959)	-	(8,835)	-

Based on the above net exposure as at December 31, 2010, 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, expressed in US dollars, as follows:

Impact to other comprehensive income	\$ 8,081		
Impact to net income (loss)		\$ (1,360)	\$ 382

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.

As at December 31, 2010, the Company has a Mexican value added tax of \$3,336 and Peruvian value added tax of \$136. The Company expects to recover the full amounts from the Mexican and Peruvian Governments.

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.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

20. Management of Financial Risk (continued)

d) Liquidity Risk (continued)

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

	Expected payments due by period as at December 31, 2010					Total
	Less than			After		
	1 year	1 - 3 years	4 - 5 years	5 years		
Accounts payable and accrued liabilities	\$ 13,496	\$ -	\$ -	\$ -	\$ 13,496	
Due to related parties, net	40	-	-	-	40	
Derivatives	133	-	-	-	133	
Long term liability	1,083	3,243	-	-	4,326	
Total ¹	\$ 14,752	\$ 3,243	\$ -	\$ -	\$ 17,995	

¹ Amounts above do not include payments related to the following: (i) the Company's anticipated asset retirement obligation of \$4,924 associated with mine closure, land reclamation, and other environmental matters.

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.

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.

FORTUNA SILVER MINES INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

(All amounts expressed in thousands of US Dollars, except for share and per share amounts)

21. Supplemental Cash Flow Information

		Years ended December 31,	
	Notes	2010	2009
Cash received or paid for interest and income taxes:			
Cash received for interest		\$ 335	\$ 210
Cash paid for income taxes		\$ 4,346	\$ 596
Non-cash Transactions:			
Issuance of shares on purchase of resource property	10 c)	\$ 20	\$ 5,194
Reassessment of asset retirement obligation	14	\$ 2,210	\$ 1,286
Cancellation of Minera Condor liability	13 b)	\$ -	\$ 156
Equipment purchased through capital lease		\$ 925	\$ 1,425
Fair value of options exercised		\$ 759	\$ 246
Disposal of investment in subsidiary		\$ 119	\$ -

22. Subsequent Event up to March 23, 2011

On January 14, 2011, the Company issued 6,756 common shares of the Company to Radius, at a fair market value of \$4.44 per share and paid \$30 cash according to the terms of the option agreement referenced in Note 10.c).



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MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE
YEAR ENDED DECEMBER 31, 2010

As at March 23, 2011

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

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

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 audited consolidated financial statements for year ended December 31, 2010 and the related notes contained therein. The Company reports its financial position, results of operations and cash flows in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). In addition, the following should be read in conjunction with the Consolidated Financial Statements of the Company for the year ended December 31, 2009, the related MD&A, and Fortuna's Annual Information Form (available on SEDAR at 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" below.

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 2010 Highlights

Financial Results

During the year ended December 31, 2010 the Company generated a net income of \$12.96 million (2009: \$0.62 million) on operating income of \$30.11 million (2009: \$14.38 million) and sales of \$74.06 million (2009: \$51.43 million). Record results were driven by increased silver production and higher silver and base metal prices.

Silver metal production during the year ended December 31, 2010 was 1,906,423 ounces, 13% above 2009. The increase was due to a combination of higher throughput (10%) and higher silver head grades (3%). Silver comprised 48% of revenue and the realized silver price was \$19.05 per ounce. Cash cost per ounce, net of by-product credits, was negative \$7.73. See the page 12 for reconciliation of cash cost to the cost of sales.

Adjusting for the mark-to-market effect on commodity contracts and a foreign exchange loss on the repatriation of funds from the Company's Peruvian subsidiary (included in the \$2.70 million foreign exchange loss recorded for the year) 2010 adjusted net income (a non-GAAP measure) totalled \$11.29 million (2009: \$2.37 million).

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

	<u>Expressed in \$ millions</u>	
	<u>Years ended December 31,</u>	
	<u>2010</u>	<u>2009</u>
NET INCOME FOR THE YEAR	\$ 12.96	\$ 0.62
Items of note, net of tax:		
Mark-to-Market effect on derivatives ⁽¹⁾	(1.33)	1.75
Foreign exchange loss on repatriation of funds from subsidiary ⁽¹⁾	2.10	-
Stock-based compensation ⁽¹⁾	(2.44)	-
ADJUSTED NET INCOME FOR THE YEAR ⁽¹⁾	\$ 11.29	\$ 2.37

⁽¹⁾ A non-GAAP measure

Cash generated by operating activities before changes in working capital (a non-GAAP measure) for the year totalled \$22.11 million, up from \$15.91 million in 2009.

San Jose Mine Construction

Construction activities for the San Jose Project commenced in the second quarter of 2010 and are on schedule for completion and commissioning of the mine in the third quarter of 2011 at an initial annual production rate of 1,000 tpd yielding 1.8 million oz silver and 16,000 oz gold. To the end of January 2011, \$29.1 million had been invested in construction or 52% of CAPEX.

Corporate Highlights

The Company's common shares began trading on the Toronto Stock Exchange (TSX) at the opening of trading on Monday, January 18, 2010 under the symbol "FVI".

In 2010, the Company entered into a credit agreement with the Bank of Nova Scotia for a \$20 million senior secured revolving credit facility to be refinanced or repaid before December 2012.

On March 3, 2010, the Company closed a bought-deal public offering for total gross proceeds of CAD\$34.5 million. The Company issued 15,007,500 shares at a price of CAD\$2.30 per share.

On December 23, 2010, the Company closed a second bought-deal public offering for total gross proceeds of CAD\$46 million. The Company issued 11,500,000 shares at a price of CAD\$4.00 per share.

On June 2010, the Company appointed Mr. Cesar Pera as Vice President of Human Resources.

On July 2010, the Company announced changes to the Board of Directors with the appointment of Mr. Robert Gilmore and the resignation of Mr. Richard Clark.

On August 2010, the Company announced the appointment of Mr. Jeffrey Franzen to the Board of Directors.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

Selected Annual Information

Expressed in \$000's, except per share data	Years Ended December 31,		
	2010	2009	2008
Sales	74,056	51,428	24,867
Income before income taxes and non-controlling interest	26,975	6,312	687
Net income (loss)	12,955	623	(910)
Earnings (loss) per share, basic and diluted	0.12	0.01	(0.01)
Total assets	243,183	139,738	115,368
Long term liability	3,166	1,454	1,382

In 2010, the Company generated record sales of \$74.06 million compared to \$51.43 million in 2009. This increase was primarily driven by higher silver prices (38%) and higher silver sales volume (15%). Total assets increased by 74% to \$243.18 million with the proceeds from the \$73.9 million bought-deal financings for the development of the San Jose Project.

In 2009, the Company generated sales of \$51.43 million compared to \$24.87 million in 2008. This increase was also primarily driven by higher silver and lead head grades, in particular silver grades which increased by 64%, higher throughput, and reduced concentrate treatment charges.

Quarterly Information

The following table provides information for the eight fiscal quarters ended December 31, 2010:

Expressed in \$000's, except per share data	Quarters Ended							
	31-Dec-10	30-Sep-10	30-Jun-10	31-Mar-10	31-Dec-09	30-Sep-09	30-Jun-09	31-Mar-09
Sales	23,908	18,039	14,565	17,543	16,356	13,230	12,862	8,980
Mine operating income (loss)	16,203	9,963	7,996	10,765	10,375	7,074	6,792	3,487
Operating income	10,570	4,678	6,972	7,891	5,563	4,388	4,355	76
Net income (loss)	4,222	(2,542)	5,980	5,296	1,037	(556)	1,196	(1,054)
Earnings (loss) per share - basic	0.04	(0.02)	0.05	0.05	0.01	(0.01)	0.01	(0.02)
- diluted	0.04	(0.02)	0.05	0.05	0.01	(0.01)	0.01	(0.02)

The past eight quarters demonstrate a clear trend of sales growth. This trend reflects both the recovery in metal prices since the beginning of 2009 and increased silver output from the Caylloma mine. Sales and operating income in the second and third quarters of 2010 reflect a decrease in base metal prices during the period.

Even though the Company achieved higher sales in Q4 and Q3 2010 as compared to Q2 2010 resulted in lower net income primarily as result of the following: higher production cash cost of 13% for Q3 and 7% for Q4; stock-based compensation expense of \$1.22 million and \$0.76 million in Q3 and Q4 2010, respectively, compared to a recovery of \$2.40 million in Q2 2010; net losses on commodity contracts of \$3.18 million in Q3

FORTUNA SILVER MINES INC.

Management's Discussion and Analysis

For the year ended December 31, 2010

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

2010 and \$0.73 million in Q4 2010 compared to a gain of \$2.90 million in Q2 2010; higher foreign exchange losses in Q3 2010 of \$1.4 million, as compared to Q2 2010 of \$0.36 million; and, write off of deferred exploration costs in Q3 2010 of \$0.44 million.

The fourth quarter of 2010 net income of \$4.22 million is primarily attributable to the record sales of \$23.91 million, offset by a commodity contract loss of \$0.73 million, a foreign exchange loss of \$0.30 million, stock-based compensation expense of \$0.76 million and bonus accrual of \$0.48 million.

Results of Operations

San Jose Mine Construction

The Company anticipates that the San Jose Project, currently under construction in Mexico, will begin to contribute both silver and gold ounces starting in the third quarter of 2011 allowing the Company to maintain its organic silver production growth in 2011.

Construction Highlights to March 23, 2011

- Processing plant construction is 33% complete. Foundation work for crushers, milling, flotation, thickening and filtering areas is complete. Mounting and installation of major plant equipment was initiated in January 2011. The 13' x 19.5' ball mill has been mounted where the milling section is 42% advanced. The three stage crushing circuit is being mounted and installed with a 66% advance. Flotation cells have arrived on site and thickeners are being mounted and installed.
- Tailings dam construction was concluded in January 2011.
- The 8MW power substation construction and commissioning has been concluded; connection to the national grid is expected in March 2011.
- The mine access ramp has reached the 1,400 meter elevation, where the first production level is being developed.
- Three stopes are being developed and prepared for the start of production in the third quarter at the initial rate of 1,000 tpd; Stope K is being developed on the Trinidad, Fortuna and Bonanza veins on sub-level 1430. Stopes L and M are being developed on level 1400. Overall advance on stope preparation is 115% against the program.
- To December 31, 2010 the mine had built an ore stock pile of 6,816 tonnes grading 234 g/t Ag and 2.13 g/t Au. The Company anticipates an inventory of approximately 30,000 tonnes before the start of commercial operations in the third quarter of 2011.
- Water pipeline installation to the mine site is 87% advanced.

Processing Plant and Ancillary Facilities

Construction of the 1,500 tpd processing plant and ancillary facilities are on schedule for commissioning at an initial rate of 1,000 tpd in the third quarter of 2011.

The processing plant has no long lead equipment on critical path. Purchase orders for all plant equipment have been placed with equipment arriving on-site according to schedule. Processing plant construction is 33% complete.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

Foundation work for crushers, milling, flotation, thickening and filtering areas is complete. Mounting and installation of major plant equipment was initiated in January 2011. The 13' x 19.5' ball mill has been mounted where the milling section is 42% advanced. The three stage crushing circuit is being mounted and installed with a 66% advance. Flotation cells have arrived on site and thickeners are being mounted and installed.

Tailings Dam

Construction of the tailings dam was concluded in January 2011. The tailings dam is currently prepared to store water for the commissioning of the processing plant. The Conagua (National Water Commission of Mexico responsible for the management and preservation of national waters and their inherent goods in order to achieve sustainable use, with joint responsibility of the three tiers of government - federal, state, and municipal, and society as a whole) technical observations to the design of the tailings facility were addressed with state and federal Conagua authorities. The Company expects approval of the final Conagua permit in the coming weeks.

Underground Mine Development

In December, the main access ramp reached the 1400 meter elevation -the first production level- allowing for the development of production stopes K, L and M for start-up of production at an initial mining rate of 1,000 tpd.

Vein widths and grades for the Trinidad, Fortuna and Bonanza veins intersect on level 1400 and sublevel 1430 are in line with the geologic resource model.

Water Sourcing

The Ocotlan grey water treatment plant is fully operational and the quality of the water obtained is within design parameters.

The pipeline to carry water from the grey water treatment plant to the Project site is 87% complete. Negotiations with a neighboring community are taking place to install the remaining two kilometers of the pipeline. Inflow to the process from the grey water treatment facility is required twenty months after the start of commercial operations.

Power Substation

Construction of the transformer and switching stations has been completed. Commissioning has been concluded and connection to the national power grid is expected during March, 2011.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

Caylloma Ag-Pb-Zn Mine

Caylloma Mine Production	Years Ended December 31,	
	2010	2009
Tonnes milled	434,656	395,560
Average tons milled per day	1,231	1,121
Silver*		
Grade (g/t)	159.24	154.76
Recovery %*	85.67	85.40
Production (Oz)*	1,906,423	1,682,546
Lead		
Grade (%)	2.44	3.10
Recovery %	91.28	93.02
Production (000's lb)	21,373	25,137
Zinc		
Grade (%)	3.10	3.66
Recovery %	87.99	89.07
Production (000's lb)	26,137	28,442
Copper		
Production (000's lb)	1,026	190
Unit Costs		
Production cash cost (US\$/oz ag)**	(7.73)	(4.86)
Production cash cost (US\$/tonne)	51.20	46.27
Unit Net Smelter Return (US\$/tonne)	163.59	124.07

* Silver in lead and copper concentrates

** Net of by-product credits

Silver production of 1,906,423 ounces, a 13% increase over the 1,682,546 ounces in 2009, exceeded 2010 guidance by 12%. This increase is attributable to an increase in mill throughput of 10%, an increase in silver recoveries of 0.3% and a 3% increase in silver head grade.

Cash cost per payable ounce silver in 2010 was negative \$7.73 net of by-product credits compared to negative \$4.86 in 2009. The change was attributable to an increased revenue from by-product credits and increased payable silver ounces of 38% and 16%, respectively, offset by an 11% increase in refining charges. See page 12 for reconciliation of cash production cost to the cost of sales.

The mill treated 434,656 tonnes of ore in 2010, compared to 395,560 tonnes in the prior year. The cash cost per tonne was \$51.20 compared to \$46.27 in 2009. Cash cost is a non-GAAP measure, see page 12 for reconciliation of cash cost to the cost of sales.

Zinc and lead production during 2010 decreased by 8% and 15%, respectively, compared to 2009. This decrease was related to a shift in the mine plan designed to replace the polymetallic ore from the Animas vein with higher grade silver ore from level 6 in the upper part of Animas vein. The mine plan shift was made

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

because of lower than expected grades from the Bateas silver vein which lead to an acceleration of the incorporation of level 6 into the production plan.

Cash cost per tonne of treated ore for the year 2010 increased by 11% to \$51.20 compared to 2009. The cost variation reflected a 2010 upward revision of underground mine contractor tariffs and labor costs directed towards reducing personnel rotation at operations, higher preparation and breakage costs at the mine, commencement of ore control drilling in 2010, local currency appreciation and preventive equipment maintenance plans that have been successful in increasing plant availability by 3% to 4%.

In 2010, 71% (2009: 85%) ore was sourced from the central and lower levels of Animas vein, 17% from level 6 in the upper part of Animas vein, and 11% (2009: 15%) from Bateas, Soledad, and Silvia veins.

Total mine development and preparation in 2010 was 12,110 meters, 56% in the Animas vein and 44% in the high-grade silver veins. The main focus of development in Animas vein was to extend mineralization along-strike towards the northeast on levels 10 and 12, and preparation of resource blocks between level 10 and level 12 with infrastructure as the mine plan extends below level 10 in 2011. In the upper part of Animas development and preparation was focused on incorporating level 6 into the production plan.

In the high grade Soledad and Silvia silver veins mine development and preparation was aimed mainly below current working levels.

In the high-grade Bateas vein exploration and development drifting focused on extending mineralization along-strike to the east and resulted in the discovery of high-grade silver ore shoots on levels 10 and 12 as reported in the press release of December 15, 2010.

The main capital projects executed in 2010 were a tailings reclassification plant for \$0.48 million, and the finalization of the feasibility study for the new tailings dam facility with an estimated total cost of \$4.2 million. The tailings reclassification plant will allow an increase in the percentage of tailings available for backfill material and the first stage of the new tailings dam will provide 7.5 years of life at current production levels.

In January 2011 production of copper-silver concentrate was discontinued at Caylloma due to a material deterioration in commercial treatment terms 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%).

FORTUNA SILVER MINES INC.**Management's Discussion and Analysis****For the year ended December 31, 2010****(Dollar amounts expressed in US dollars, unless otherwise indicated)**

Caylloma Mine Concentrates	Years Ended December 31,	
	2010	2009
Zinc		
Opening Inventory (t)	369	295
Production (t)	22,291	23,700
Sales (t)	22,419	23,563
Adjustment (t)	22	(63)
Closing Inventory (t)	263	369
Ag in concentrate (g/t)	96	95
Zn in concentrate (%)	53	54
Lead		
Opening Inventory (t)	408	17
Production (t)	15,015	18,078
Sales (t)	15,250	17,715
Adjustment (t)	14	28
Closing Inventory (t)	188	408
Ag in concentrate (g/t)	1,499	2,567
Pb in concentrate (%)	65	63
Copper		
Opening Inventory (t)	46	0
Production (t)	2,085	411
Sales (t)	2,117	366
Adjustment (t)	15	1
Closing Inventory (t)	29	46
Ag in concentrate (g/t)	17,644	14,496
Cu in concentrate (%)	22	21

Financial Results

During the year ended December 31, 2010 the Company generated net income of \$12.96 million (2009: \$0.62 million) on operating income of \$30.11 million (2009: \$14.38 million).

Sales for the year were \$74.06 million (2009: \$51.43 million). Increased sales were partially offset in operating income by a higher cash cost per tonne of \$51.20 (2009: \$46.27). Operating income also includes higher corporate selling, general and administrative expenses of \$5.23 million compared to 2009. These expenses were associated with the growth of the Company, legal fees related to the credit facility, development of corporate projects and bonus payments.

Net income includes commodity contracts gain of \$0.74 million (2009: loss \$7.36 million), foreign exchange loss of \$2.70 million (2009: \$0.65 million), and stock-based compensation recovery of \$0.42 million (2009: expense \$2.71 million).

Sales increased by 44% to \$74.06 million (2009: \$51.43 million) compared to a year ago. The increase is primarily attributable to higher silver prices (38%) and higher sales volume (15%). Zinc and lead metal sold

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

were below last year (7% and 11%, respectively) with zinc and lead prices above last year (31% and 25%, respectively).

Caylloma Mine Metal Sold and Prices	Years Ended December 31,	
	2010	2009
Silver		
Sales (Oz)*	1,894,703	1,645,629
Realized Price (US\$/Oz)**	19.05	13.75
Average Price (US\$/Oz)	20.16	14.65
Lead		
Sales (000's lb)*	21,461	24,184
Realized Price (US\$/lb)**	0.80	0.61
Average Price (US\$/lb)	0.97	0.78
Zinc		
Sales (000's lb)*	26,306	28,175
Realized Price (US\$/lb)**	0.60	0.42
Average Price (US\$/lb)	0.98	0.73
Copper		
Sales (000's lb)*	1,021	163
Realized Price (US\$/lb)**	2.67	1.59
Average Price (US\$/lb)	3.42	2.34
Gold		
Sales (Oz)*	2,411	2,397
Realized Price (US\$/Oz)**	939.45	812.08
Average Price (US\$/Oz)	1,225.07	972.98

* 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.

Cost of sales increased by 25% to \$22.27 million (2009: \$17.76 million) compared to last year. The increase is primarily attributable to an 11% higher unit production cash costs and increased throughput of 10%. Refer to Page 7 discussion on cash cost per tonne of treated ore.

Operating income increased by 109% to \$30.11 million (2009: \$14.38 million) compared to 2009. The increase is primarily attributable to higher sales, a 115% decrease in stock-based compensation, a 59% decrease in write-off of deferred exploration costs and a 15% increase in depletion, depreciation and accretion. These savings were offset by a 25% increase in cost of sales, and a 55% increase in selling, general and administrative expenses.

Selling, general and administrative expenses increased by 55%, in 2010, to \$14.79 million (2009: \$9.56 million). The increase is primarily attributable to corporate general and administrative expenses associated with the growth of the Company, legal fees related to the credit facility with the Bank of Nova Scotia and bonus payments.

FORTUNA SILVER MINES INC.**Management's Discussion and Analysis****For the year ended December 31, 2010****(Dollar amounts expressed in US dollars, unless otherwise indicated)**

	Expressed in \$ millions			
	Years ended December 31,			
	2010		2009	
Corporate general and administrative expenses	\$	8.32	\$	4.06
Peruvian subsidiary :				
general and administrative expenses	\$	2.99	\$	3.08
selling expense (including trucking of concentrate)		2.69		1.93
government royalty		0.79		0.49
	\$	6.47	\$	5.50
	\$	14.79	\$	9.56

Stock-based compensation recovery of \$0.42 million (2009: expense \$2.71 million) is primarily attributable to the cancellation of 2,665,000 share purchase options as shareholder approval was not obtained at the Company's annual general meeting held on June 23, 2010 resulting in a stock-based compensation recovery of \$2.44 million. In addition, stock-based compensation is impacted by the mark-to-market value of the Company's deferred and restricted share units of \$2.02 million (2009: \$nil).

Interest and other (expenses) income decreased by 188% to an expense of \$0.38 million (2009: income \$0.43 million) compared to a year ago. The increase in costs is primarily attributable to the dividend withholding tax paid of \$0.27 million (2009: \$nil) offset by an increase in interest income arising from higher interest rates applied to higher cash and cash equivalents and short term investments balances.

Interest and finance expenses, increased by 240% to \$0.54 million (2009: \$0.16 million) compared to a year ago. The increase is primarily attributable to the commitment and standby fees associated with the Bank of Nova Scotia credit facility and capital lease obligations at our operating subsidiary.

Net gain (loss) on commodity contract increased to a net gain of \$0.74 million (2009: loss (\$7.36 million)). The gain reflected the change in fair value of derivative contracts between the opening of the reporting period and either the expiry of the contracts or the closing of the period, whichever happened first. Included in the \$0.74 million gain is a mark-to-market effect of \$2.12 million (\$1.33 million, net of tax), related to open contracts as at December 31, 2010 expiring March 2011. The Company occasionally enters into commodity forward and option contracts to secure a minimum price level on part of Caylloma's zinc and lead metal production. Additionally, for the unhedged balance of production, the Company enters regularly into short term forward lead and zinc and silver option 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. The Company does not use hedge accounting.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

Price protection program - Derivatives

As at December 31, 2010, the Company had the following contracts outstanding:

<i>Type of contract</i>	<i>Metal</i>	<i>Total tonnage (t) or ounces (oz)</i>	<i>Settlement period</i>	<i>Price/t or Price/oz</i>
<i>Forward sale</i>	<i>Lead</i>	<i>210 t</i>	<i>March 2011</i>	<i>\$2,500/t</i>
<i>Forward sale</i>	<i>Zinc</i>	<i>240 t</i>	<i>March 2011</i>	<i>\$2,415/t</i>
<i>Long put</i>	<i>Silver</i>	<i>90,000 oz</i>	<i>January 2011</i>	<i>\$28.00/oz</i>
<i>Short call</i>	<i>Silver</i>	<i>90,000 oz</i>	<i>January 2011</i>	<i>\$32.10/oz</i>
<i>Long put</i>	<i>Silver</i>	<i>50,000 oz</i>	<i>January 2011</i>	<i>\$29.00/oz</i>
<i>Short call</i>	<i>Silver</i>	<i>50,000 oz</i>	<i>January 2011</i>	<i>\$31.70/oz</i>

Foreign exchange loss, increased four-fold to \$2.70 million (2009: \$0.65 million). The increase is primarily attributable to the \$2.10 million foreign exchange loss realized upon the repatriation of funds from the Company's Peruvian subsidiary.

Income tax provision increased by 139% to \$14.02 million (2009: \$5.87 million). Income tax provision is comprised of current and future income tax expense. Current income tax for the period, including the worker profit sharing plan regulated by Peruvian law, totalled \$10.94 million (2009: \$5.08 million). Future income tax expense, amounting to \$3.08 million (2009: \$0.79 million) was attributed to temporary differences arising on amounts of mineral properties at Peruvian operations where exploration and development are expensed for tax purposes.

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 within Canadian Generally Accepted Accounting Principles ("Canadian GAAP") and, therefore, amounts presented may not be comparable to similar data presented by other mining companies.

The following table presents a reconciliation of cash costs per tonne of processed ore and cash cost per ounce of payable silver to the cost of sales in the Consolidated Statement of Operations for the years ended December 31, 2010 and 2009.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

	\$'000's	
	Years ended December 31,	
	2010	2009
Cost of sales	29,129	23,699
Add / (Subtract)		
Change in concentrate inventory	(305)	549
Inventory adjustment	290	-
Depletion, depreciation, and accretion	(6,859)	(5,944)
Cash cost	22,255	18,304
Total processed ore (tonnes)	434,656	395,561
Cash cost per tonne of processed ore (\$/t)	51.20	46.27
Cash cost	22,255	18,304
Add / (Subtract)		
By-product credits ¹	(37,825)	(27,318)
Refining charges	1,576	1,416
Cash cost applicable per payable ounce	(13,994)	(7,598)
Payable silver ounces	1,811,102	1,563,775
Cash cost per ounce of payable silver (\$/oz)	(7.73)	(4.86)

¹ By-product credits as included in the provisional liquidation

Liquidity and Capital Resources

The Company's cash and cash equivalents as at December 31, 2010 totalled \$70.30 million, and short term investments totalled \$20.51 million. Working capital amounted to \$97.09 million.

During 2010, cash generated by operating activities before changes in working capital was \$22.19 million. Changes in working capital amounted to \$1.08 million, resulting in cash generated by operating activities of \$21.11 million.

During 2010, cash consumed by the Company in investing activities totalled \$57.39 million with \$16.60 million for mineral properties, \$19.82 million for property, plant and equipment, \$4.29 million for deposits on long term assets, and short term investments of \$13.86 million. The total investment in San Jose amounted to \$27.90 million and included \$8.12 million for mineral properties, \$15.39 million for property, plant and equipment, and \$4.39 million for deposits on long term assets.

During 2010, cash generated by financing activities totalled \$73.69 million comprised of net proceeds on the issuance of common shares of \$74.92 million less the repayment of capital lease obligations of \$1.23 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

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

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 year.

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

	San Jose Project Financing		
	Expressed in CAD \$ millions		
	Actual Use		
	Expected Use	of	
	of Proceeds*	Proceeds**	Variance
Mine development	\$ 6.7	\$ 3.3	\$ 3.4
Processing plant	16.6	4.8	11.8
Tailings dam	1.9	3.9	(2.0)
Water and Infrastructure	3.0	2.4	0.6
Energy supply	-	2.2	(2.2)
Construction management	-	1.0	(1.0)
Total	\$ 28.2	\$ 17.6	\$ 10.6

*excludes over-allotment

**US CAD FX rate at 1.0

Prospectus December 17, 2010 Closed December 23, 2010

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

*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:

- 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 an annual collateral in the form of a letter of guarantee, to be awarded each year in increments of \$146 over 12 years, and is 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

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

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 expire 360 days from June 2010.

Interbank, a third party, has renewed the bank letter of guarantee in the amount of \$2, in favor of the Peruvian Ministry of Energy and Mines, to allow a temporary concession to study electric power generation in the hydro electric power plant, to expire April 2011.

The Company acts as guarantor to capital lease obligations held by two of its mining contractors. These capital lease contracts are related to the acquisition of mining equipment deployed at the Caylloma mine. As at December 31, 2010, these obligations amounted to \$711 with \$231 and \$480 maturing in 2011 and 2012, respectively.

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.

Related Party Transactions (expressed in \$'000's)

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

Transactions with related parties	Expressed in \$'000's	
	Years ended December 31,	
	2010	2009
Consulting fees ¹	\$ 175	\$ 145
Salaries and wages ^{2,3}	174	122
Other general and administrative expenses ³	185	159
	\$ 534	\$ 426

¹ Consulting fees includes fees paid to two directors, Simon Ridgway and Mario Szotlender.

² 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.

^{2,3} Radius Gold Inc. ("Radius") has directors in common with the Company and shares office space, and is reimbursed for various general and administrative costs incurred on behalf of the Company.

In September 2009, the Company was granted an option to acquire a 60% interest in the Tlacolula silver project located in the State of Oaxaca, Mexico from Radius.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

Amounts due to/(from) related parties are comprised of the following:

Amounts due to/(from) related parties	Expressed in \$'000's	
	December 31, 2010	December 31, 2009
Owing (from)/to a director and officer ⁴	\$ (1)	\$ (1)
Owing to a company with common directors ³	\$ 41	\$ 50
	\$ 40	\$ 49

⁴ Owing from a director includes non-interest bearing advances to Jorge A. Ganoza Durant at December 31, 2010 and 2009 .

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.

Critical Accounting Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. These estimates and assumptions are based on established industry standards, historical experience, and are reviewed on an ongoing basis to confirm their continued applicability.

Depletion and Mineral Properties Cost

Mineral property costs are comprised of acquisition costs and capitalized exploration, construction, and development costs. Upon initiating production, the asset is depleted over its estimated useful life on a units-of-production basis. The Company estimates reserves and resources and the economic life of its mines and utilizes this information to calculate depletion expense. Depletion charges are adjusted prospectively based on periodic re-assessments of the Company's mineral reserves.

The estimate of mineral reserves is prepared by Qualified Persons in accordance with industry standards defined under NI 43-101 of the Canadian Securities regulatory authorities. Mineral reserve estimates can change over time as a result of numerous factors, including changes in metal prices, production costs, or the re-evaluation of geological, engineering, and economic data of a deposit. A significant reduction in mineral reserves would have a negative impact on the calculation of the depletion of this asset.

Asset Retirement Obligations

Fortuna's determination for asset retirement obligations involves estimation of timing and amounts of future costs relating to ongoing environmental and mine closure activities required under applicable law or the Company's own remediation plans. These estimates are subject to significant uncertainties because many of these costs will not be incurred for a number of years, the nature of the reclamation activities might change and the assumptions regarding the rate of inflation and credit risk-adjusted interest rate used in the calculation may vary over time. Therefore, actual costs and their timing might differ from current estimates.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

Impairment of Long-lived Assets

Management reviews and evaluates its long-lived assets for impairment when events or changes in circumstances indicate that the related carrying amounts may not be recoverable. Examples of such events or circumstances are changes in metal prices, sudden physical deterioration of the asset, legal circumstances or political risks in the countries Fortuna operates, or other external factors which could have a significant impact on the operations of the Company. Impairment is considered to exist if total estimated future cash flows or probability-weighted cash flows on an undiscounted basis are less than the carrying amount of the assets, including mineral property, plant and equipment and non-producing property. An impairment loss is measured and recorded based on discounted estimated future cash flows or the application of an expected present value technique to estimate fair value in the absence of a market price. Future cash flows include recoverable proven and probable reserves and a portion of recoverable resources, silver, zinc, copper, lead and gold prices (considering current and historical prices, price trends and related factors), production levels, capital and reclamation costs, all based on detailed engineering life-of-mine plans. Assumptions underlying future cash flow estimates are subject to risks and uncertainties. Any differences between significant assumptions and market conditions and/or the Company's performance could have a material effect on any impairment provision, and on the Company's financial position and results of operations.

Income Taxes

The estimation of the Company's future tax liabilities and assets involves significant judgment around a number of assumptions. Judgement must be used to determine the Company's future earning potential, and the expected timing of the reversal of future tax assets and liabilities. Further uncertainties are the result of interpretation of tax legislation in a number of jurisdictions which might differ from the ultimate assessment of the tax authorities. These differences may affect the final amount or the timing of the payment of taxes.

Stock-based Compensation

i. Stock Option Plan

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

ii. Deferred Share Unit Plan ("DSU")

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

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

iii. Restricted Share Unit Plan ("RSU")

The Company recognizes a compensation cost in operating income on a prescribed vesting basis for each RSU granted equal to the 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 market value until the end of the performance date. The cumulative effect of the change in market value is recognized in operating income in the period of change.

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.

(a) Fair value of financial instruments

The carrying value of cash and cash equivalents, short term investments, accounts receivable, accounts payable and accrued liabilities, 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.

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.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

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

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

Financial assets (liabilities) at fair value as at December 31, 2009				
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 30,763	\$ -	\$ -	\$ 30,763
Short term investments	6,034	-	-	6,034
Accounts receivable	-	8,322	-	8,322
Derivatives	-	(3,055)	-	(3,055)
	\$ 36,797	\$ 5,267	\$ -	\$ 42,064

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 year ended December 31, 2010, there have been no changes in the classification of financial assets and liabilities in level 3 of the hierarchy.

(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, Mexico and Barbados 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 results of operations, financial position, or cash flows. The Company has not hedged its exposure to currency fluctuations.

As at December 31, 2010, 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):

FORTUNA SILVER MINES INC.**Management's Discussion and Analysis****For the year ended December 31, 2010****(Dollar amounts expressed in US dollars, unless otherwise indicated)**

	Expressed in '000's					
	December 31, 2010			December 31, 2009		
	Canadian Dollars	Nuevo Soles	Mexican Pesos	Canadian Dollars	Nuevo Soles	Mexican Pesos
Cash and cash equivalents	\$ 54,782	S/. 741	\$ 2,201	\$ 21,283	S/. 302	\$ 1,283
Short term investments	20,514	-	-	560	-	-
Accounts receivable	71	1,304	42,452	5	880	6,565
Long term investment and receivable	-	-	24,209	-	-	-
Accounts payable and accrued liabilities	(625)	(27,268)	(6,390)	(194)	(17,150)	(623)
Long term liability	(1,999)	-	-	-	-	-
Asset retirement obligation	-	(9,169)	(19,959)	-	(8,835)	-

Based on the above net exposure as at December 31, 2010, 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, expressed in US dollars, as follows:

Impact to other comprehensive income	\$ 8,081		
Impact to net income (loss)		\$ (1,360)	\$ 382

(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.

As at December 31, 2010, the Company has a Mexican value added tax of \$3.34 million and Peruvian value added tax of \$0.14 million. The Company expects to recover the full amounts from the Mexican and Peruvian Governments.

(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.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

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

	Expressed in \$'000's					Total
	Expected payments due by period as at December 31, 2010					
	Less than 1 year	1 - 3 years	4 - 5 years	After 5 years		
Accounts payable and accrued liabilities	\$ 13,496	\$ -	\$ -	\$ -	\$ -	\$ 13,496
Due to related parties, net	40	-	-	-	-	40
Derivatives	133	-	-	-	-	133
Long term liability	1,083	3,243	-	-	-	4,326
Total¹	\$ 14,752	\$ 3,243	\$ -	\$ -	\$ -	\$ 17,995

¹ Amounts above do not include payments related to the following: (i) the Company's anticipated asset retirement obligation of \$4,924 associated with mine closure, land reclamation, and other environmental matters.

(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.

(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.

Other Data

Additional information related to the Company is available for viewing at www.sedar.com and the Company's website at www.fortunasilver.com.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

Share Position and Outstanding Warrants and Options

The Company's outstanding share position as at March 23, 2011 is 122,749,221 common shares. In addition, a total of 4,305,500 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
	7,500	\$0.85	July 5, 2016
	225,000	\$1.55	July 5, 2016
	825,000	\$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
	20,000	\$0.85	February 6, 2017
	38,000	\$0.85	June 27, 2017
	5,000	\$0.85	July 2, 2017
	25,000	\$0.85	October 24, 2017
	250,000	\$2.52	February 5, 2018
	810,000	\$0.85	October 5, 2018
	240,000	\$0.85	November 5, 2018
	205,000	\$0.83	July 6, 2019
TOTAL OUTSTANDING OPTIONS	<u>4,305,500</u>		

Change in Accounting Policy

Adoption of New Accounting Standards

The Company has not adopted any new accounting standards during the year.

Recently released Canadian Accounting Standards

The Company has assessed new and revised accounting pronouncements that have been issued and determined that the following will have an impact on the Company:

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

Convergence with International Financial Reporting Standards ("IFRS")

In 2006, the Canadian Accounting Standards Board ("AcSB") published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian GAAP with International Financial Reporting Standards ("IFRS") over an expected five year transitional period. In February 2008, the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canadian GAAP. This date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The Company will begin reporting its financial statements in accordance with IFRS on January 1, 2011, with comparative figures for 2010.

The adoption date of January 1, 2011 will require the restatement, for comparative purposes, of amounts reported by the Company for its year ended December 31, 2010, and of the opening balance sheet as at January 1, 2010.

IFRS Project Overview

The Company continues to advance through its IFRS transition project plan.

During 2009, the Company began planning its transition to IFRS. The process consists of three phases: Scoping and Diagnostics, Analysis and Development, and Implementation and Review.

Phase One: Scoping and Diagnostics, which involved project planning and identification of differences between current Canadian GAAP and IFRS, was completed in the third quarter of 2009 with the assistance of external advisors.

The resulting identified areas of accounting difference of highest potential impact to the Company, were: IFRS 1 "First-time Adoption of IFRS"; International Accounting Standard ("IAS") 21 "The Effects of Changes in Foreign Exchange Rates"; and, IAS 16 "Property, Plant and Equipment".

Phase Two: Analysis and Development involved detailed diagnostics and evaluation of the financial impacts of various options and alternative methodologies provided for under IFRS: identification and design of operational and financial processes; initial staff training; analysis of IFRS 1 optional exemptions and mandatory exceptions to the general requirement for full retrospective application upon transition to IFRS; summarization of 2011 IFRS disclosure requirements; and development of required solutions to address identified issues.

Following the completion of the scoping and diagnostic assessment, the Company engaged external advisors to assist with detailed technical reviews of the identified potential high impact areas. These reviews included the identification of IFRS - Canadian GAAP differences, accounting policy considerations, and preliminary implementation plans. The high impact areas relating to conversion include foreign currency; property, plant and equipment; income taxes; and provisions, contingent liabilities and contingent assets (including asset retirement obligations). During the second quarter of 2010, the technical review aspects of these assessments were substantially completed. During the third and fourth quarters of 2010, the Company substantially completed the preliminary opening balance sheet quantification of the identified technical differences and quantification of the impacts of IFRS transition on the first three quarters of 2010.

FORTUNA SILVER MINES INC.

Management's Discussion and Analysis

For the year ended December 31, 2010

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

Phase Three: Implementation and Review, will involve the execution of changes to information systems and business processes; completion of formal authorization processes to approve recommended accounting policy changes; integration of appropriate changes to maintain the integrity of internal controls over financial reporting and disclosure controls and procedures; and further training programs across the Company's finance and other affected areas, as necessary. It will culminate in the collection of financial information necessary to compile IFRS-compliant financial statements and reconciliations; embedding of IFRS in business processes; and, audit committee approval of IFRS-compliant financial statements. This phase commenced in the third quarter of 2010.

The Company will continue to monitor changes in IFRS leading up to the changeover date, and will update the conversion plan as required. Changes in circumstances may cause the Company to revise its IFRS opening balance sheet and policy choices before the changeover date. The opening balance sheet will be published in the first quarter of 2011.

First Time Adoption Elections and Accounting Policy Changes

At the present time the Company is planning to apply five of the 17 elections within IFRS 1 which include:

- IFRS 3 "Business Combinations" which allows an entity that has conducted prior business combinations to apply IFRS 3 on a prospective basis only from the date of transition. This avoids the requirement to restate prior business combinations, although some adjustments may still be necessary.
- IFRS 2 "Share-based Payment" which allows full retrospective application to be avoided for certain share-based instruments depending on the grant date, vesting terms and settlement of any related liabilities.
- IAS 21 "The Effects of Changes in Foreign Exchange Rates" which allows for the cumulative translation differences that existed at the date of transition to IFRS to be reset to zero.
- IAS 23 "Borrowing Costs" which allows full retrospective application to be avoided by electing an effective date as the date of transition, January 1, 2010, to IFRS.
- IAS 37 "Provisions, Contingent Liabilities and Contingent Assets" which allows a short cut method in recalculating both the decommissioning liability and asset at the transition date of January 1, 2010. This avoids the requirement to recalculate the liability retrospectively from the date of recognition and then re-measure it at each subsequent reporting period up until the date of transition.

Below is a preliminary summary of the impacts of the high impact areas relating to conversion to IFRS and their expected impact on the Company:

a) Foreign Currency

Under IAS 21, it is necessary to assess the functional currency of all the Company's entities based on the primary economic environment in which the entity operates. In addition, secondary factors may also provide evidence of an entity's functional currency. Once the functional currency is determined, it does not change unless there is a change in the underlying nature of the transactions and relevant conditions and events.

All entities that have a Canadian GAAP measurement currency that is different than the functional currency under IFRS will need to translate their balance sheets to the functional currency at the transition date. The Company's preliminary analysis determined that Compania Minera Cuzcatlan S.A. de C.V., Fortuna Silver

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

Mines Peru S.A.C., and Recursos del Golfo, S.A. change from a Canadian dollar ("CAD\$") measurement currency under Canadian GAAP to a United States dollar ("US\$") functional currency under IFRS.

The Company intends to continue with a US\$ presentation currency under IFRS.

The Company is planning to take the IFRS 1 exemption that resets the cumulative translation adjustment balance ("CTA") to zero, to reduce the conversion effort. This will result in the reclassification of the CTA existing balance into deficit on transition to IFRS on January 1, 2010, in the preliminary amount of \$2.90 million.

The preliminary adjustments for the opening balance sheet includes a foreign currency reduction to property, plant and equipment and mineral properties of \$0.33 million and \$2.20 million, respectively.

b) Property, Plant and Equipment

Under IAS 16, each part of an item of property, plant and equipment with a cost that is significant in relation to the total costs of an item is depreciated separately. This is commonly referred to as component depreciation. Each separate part is depreciated over its useful economic life to the residual value. Under IFRS, the assessment of the useful economic life and the residual value of each part of the asset are determined on an annual basis. The Company has completed a detailed review of fixed assets and preliminarily concluded that there will be no transitional adjustments as a result of this issue.

Under IFRS, there is an option to use either the cost method or the revaluation model for subsequent measurement of classes of property, plant and equipment. The Company plans to continue to use the cost method.

Canadian GAAP does not specifically state how to treat borrowing costs related to the construction of an asset, whereas IFRS states that borrowing costs that are directly attributable to the acquisition or construction of a qualifying asset shall be capitalized as part of the cost of that asset on a net basis. The Company has elected to apply the borrowing cost requirements effective January 1, 2010.

For impairment, Canadian GAAP generally uses a two-step approach to testing: first comparing asset carrying values with undiscounted future cash flows to determine whether impairment exists, and then measuring any impairment by comparing asset carrying values with fair values. IAS 36, "Impairment of Assets", uses a one-step approach for both testing for and measurement of impairment, with carrying values compared directly with the higher of fair value less costs to sell and value in use (which uses discounted future cash flows). This may potentially result in more write-downs when carrying values of assets are supported under Canadian GAAP on an undiscounted cash flow basis, but could not be supported on a discounted cash flow basis.

However, the extent of any new writedowns may be partially offset by the requirement under IAS 36 to reverse any previous impairment losses where circumstances have changed such that the impairments have been reduced. Canadian GAAP prohibits reversal of impairment losses.

The Company has preliminarily concluded that there will be no impairment adjustments required at the transition date to IFRS.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

c) Income Taxes

Under Canadian GAAP, current and future income tax assets and liabilities are referred to as "future income tax" ("FIT") assets or liabilities whereas under IFRS the terminology is "deferred tax". There are no accounting policy choices available upon transition to IAS 12 "Income Taxes".

The preliminary analysis completed to date has identified two significant differences in the area of accounting for income taxes.

Canadian GAAP has a specific exemption for future income taxes related to non-monetary assets or liabilities of integrated foreign operations. Future income taxes cannot be recognized for a temporary difference arising from the difference between the historical exchange rate and the current exchange rate translation of the cost of non-monetary assets or liabilities of integrated foreign operations. Under IFRS, deferred tax is recognized on the difference between: the accounting basis of all items. For foreign currency non-monetary assets or liabilities, this is the local or tax basis currency translated into the functional currency at the historical rate; and the tax basis, which is the local or tax basis currency amount translated to the functional currency at the spot exchange rate at the balance sheet date. The result of this calculation difference will be added volatility in the tax expense as foreign exchange changes will have a more pervasive impact on tax expense.

IAS 12 does not permit recognition of a temporary difference on initial recognition, except if the transaction is a business combination or if the transaction affects accounting or taxable profit or loss. Under Canadian GAAP, where assets are acquired other than in a business combination and a temporary difference arises the associated FIT asset (subject to the more likely than not test) or liability is recognized at the time of acquisition and added to the cost of the asset. The amount of the FIT is calculated using a simultaneous equation; this method of tax calculation is referred to as the 'gross up' method. Under IAS 12, any temporary differences arising on subsequent asset acquisitions, other than in a business combination, would be ignored. On adoption of IFRS, the temporary differences arising from the 'gross up' method under Canadian GAAP will be reversed.

In addition, IFRS requires additional disclosure with respect to "outside basis" differences not recognized in the tax provision. These "outside basis" differences are essentially any tax liability that would result on accounts that are eliminated upon consolidation (for example: intercompany loans, intercompany dividends, or investments). The Company has some outside basis differences arising from foreign exchange rates on loans denominated in United States dollars.

The preliminary adjustment to the future income tax liability opening balance sheet amounts to a reduction of \$5.38 million comprised of the following: reversal of future income tax of \$1.09 million related to workers' participation; \$3.47 million related to temporary differences on business combinations; \$0.15 million related to provision; and, \$0.67 million related to foreign currency adjustments.

d) Provisions, Contingent Liabilities and Contingent Assets (including asset retirement obligations)

Under Canadian GAAP, the Company recognizes decommissioning liabilities where there is a legal obligation as compared to IFRS requiring including both legal and constructive obligations. The preliminary analysis has determined there are no additional constructive obligations for the Caylloma mine or the San Jose Project.

Under Canadian GAAP, the Company applies a credit adjusted risk free interest rate to the undiscounted cash flow estimate at each site. IFRS requires the Company to use a pre-tax discount rate, typically a long term

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

government bond rate in the jurisdiction the Company intends to raise the financing to meet the reclamation costs. In addition, under Canadian GAAP, the estimate of cash flows is based on a third party concept and cannot be based on the Company's calculated cost of using its own equipment. IFRS allows a Company to use internal cost estimates if the Company is likely to use its own machinery and labour to perform the reclamation work.

The Company has elected to take the IFRS 1 exemption to avoid the requirement to recalculate the liability retrospectively from the date of recognition and then re-measure it at each subsequent reporting period up until the date of transition.

On a go forward basis, the Company will be required to present accretion as a finance cost under IFRS. In addition, there will be differences due to the subsequent re-measurement of the decommissioning liability.

The preliminary adjustment to the asset retirement obligation opening balance sheet amounts to an increase of \$0.39 million.

e) Other

The Company considered both IFRS 2 - "Share-based Payment" and IFRS 6 - "Exploration for and Evaluation of Mineral Resources" as part of its initial diagnostic assessment. The Company has concluded that there will be no significant or material transitional adjustments or changes in reported results arising from the application of these standards upon transition to IFRS.

Outlook on Future Earnings

Future net earnings will be impacted by the change in the accounting methodology of recognizing deferred taxes that arise on foreign non-monetary assets or liabilities. The result of this calculation difference will be added volatility in the tax expense as foreign exchange swings will have an impact on the tax expense.

Quantitative Impact on Transition to IFRS

Based on the analysis completed to date, the Company expects the following impact on shareholders equity on transition to IFRS:

	Expressed in \$ millions
Shareholders' Equity, Canadian GAAP, December 31, 2009	\$ 112.56
Adjustments:	
Effect of foreign exchange on property, plant and equipment	(2.54)
Deferred income tax adjustments	1.48
Transfer of accumulated other comprehensive income to deficit	2.90
Reset accumulated other comprehensive income to zero	(2.90)
Asset retirement obligation adjustments	(0.32)
Shareholders' Equity, IFRS, January 1, 2010	\$ 111.18

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

Internal Control over Financial Reporting and Disclosure Controls and Procedures

The Company has considered the short term effects the IFRS transition will have on our internal controls over financial reporting and disclosure controls and procedures. We will continue to monitor and assess these controls on an on-going basis.

Business Activities and Key Performance Measures

The Company has considered what effects the IFRS transition will have on our business policies and activities. The following key areas are likely to be affected:

- Internal controls over financial reporting with respect to the IFRS transition project;
- Dual reporting obligation for the year 2010 because statements are required under both Canadian GAAP and IFRS for that year;
- Budgeting and Forecasting activities during the IFRS transition year, 2010. The budgeting process for 2011 factored in IFRS related impacts that have been identified; and,
- Key performance measures.

Financial Reporting Expertise in IFRS

The Company is maintaining its financial reporting expertise and competencies by addressing training requirements through IFRS sessions provided by external advisors. The training is targeted to key finance staff and will continue to be delivered in 2011.

IT Systems

The extent of the impact of the Company's information systems for transitioning to IFRS has been determined. The adoption of IFRS will have an impact on the Company's information systems in particular the process of consolidating information for reporting of the external financial statements. The Company has commenced a process of changing its consolidation. During the third quarter, the Company engaged a third party to assist with implementing modifications to ensure an efficient conversion to IFRS.

Other Risks and Uncertainties

There have been no major changes from the reported risks factors outlined in the Annual Information Form dated March 31, 2010.

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 December 31, 2010, 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.

FORTUNA SILVER MINES INC.
Management's Discussion and Analysis
For the year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

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.

Outlook

The Company anticipates that the San Jose Project, currently under construction in Mexico, will begin to contribute both silver and gold ounces starting in the third quarter of 2011 allowing Fortuna to maintain its organic silver production growth in 2011.

Once San Jose is in operation in the third quarter of 2011, Management anticipates that Fortuna's operations at Caylloma and San Jose should produce a total of 2.4 million ounces of silver and 7,530 ounces of gold or 2.8 million silver equivalent ounces (*) plus base metal credits in 2011. San Jose's contribution will be 500,000 ounces of silver and 4,580 ounces of gold. The Company is executing plans to reach a production rate of 7 million ounces of silver equivalent annual production from existing reserves by 2013.

2011 Production Guidance

Mine	Silver (oz)	Gold (oz)	Zinc (lbs)	Lead (lbs)	Copper (lbs)
Caylloma, Peru	1,900,000	2,950	25,200,000	16,600,000	760,000
San Jose, Mexico	500,000	4,580	--	--	--
Total :	2,400,000	7,530	25,200,000	16,600,000	760,000

(*) Based on Ag = US\$ 23.60/oz, Au = US\$ 1,350/oz and metallurgical recoveries of 88% and 90% for Ag and Au respectively

In 2012, its first full year of production, the San Jose Mine is scheduled to produce 1.77 million ounces of silver and 16,120 ounces of gold or 2.75 million silver equivalent ounces. At full design capacity, planned for late 2013 (24 months from the start of operations), the San Jose Mine's annual production forecast is 3.2 million ounces of silver, 24,220 ounces of gold or 4.6 million silver equivalent ounces.

FORTUNA SILVER MINES INC.

Management's Discussion and Analysis

For the year ended December 31, 2010

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

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 year ended December 31, 2010
(Dollar amounts expressed in US dollars, unless otherwise indicated)

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, 2009 filed with the Canadian Securities Administrators and available at 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.