

BAFFINLAND IRON MINES CORPORATION
A Development Stage Entity

Financial Statements
December 31, 2006

Auditors' Report

To the Shareholders of
Baffinland Iron Mines Corporation

We have audited the balance sheet of Baffinland Iron Mines Corporation (the "Company") as at December 31, 2006 and the statements of operations and deficit and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The financial statements as at December 31, 2005 and for the year then ended were audited by other auditors who expressed an opinion without reservation on those financial statements in their report dated March 8, 2006 except for note 2 which was dated August 1, 2006.

PricewaterhouseCoopers LLP

Chartered Accountants
Toronto, Ontario, Canada
January 15, 2007

BAFFINLAND IRON MINES CORPORATION**(Development Stage Entity)****BALANCE SHEETS**

As at December 31,

	<u>2006</u>	<u>2005</u>
ASSETS		
Current		
Cash and cash equivalents (Note 3)	\$ 12,451,283	\$ 19,392,827
Accounts receivable	388,979	377,341
Prepaid expenses	1,136,134	331,790
	<u>13,976,396</u>	<u>20,101,958</u>
Mining interests (Note 4)	1	1
Capital assets (Note 5)	846,126	101,155
	<u>\$ 14,822,523</u>	<u>\$ 20,203,114</u>
LIABILITIES		
Current		
Accounts payable	\$ 2,669,565	\$ 694,212
Due to related parties (Note 9)	-	123,347
	<u>2,669,565</u>	<u>817,559</u>
Future income tax liability (Note 8)	<u>3,650,963</u>	<u>5,000,000</u>
	6,320,528	5,817,559
SHAREHOLDERS' EQUITY AND DEFICIT		
Capital stock (Note 6)	47,093,202	34,080,431
Contributed surplus (Note 6)	4,649,523	2,475,987
Deficit	<u>(43,240,730)</u>	<u>(22,170,863)</u>
	8,501,995	14,385,555
	<u>\$ 14,822,523</u>	<u>\$ 20,203,114</u>

The accompanying notes are an integral part of the financial statements

BAFFINLAND IRON MINES CORPORATION
(Development Stage Entity)
STATEMENTS OF OPERATIONS AND DEFICIT
For the years ended,

	<u>2006</u>	<u>2005</u>	<u>Cumulative from January. 1 2003</u>
Interest and other income	<u>\$1,144,844</u>	<u>\$155,053</u>	<u>\$1,370,864</u>
Expenses			
Exploration	26,474,541	15,035,193	50,319,234
Amortization	94,990	11,956	113,393
Salaries	774,779	277,500	1,242,447
Stock-based compensation (Note 7)	2,173,536	588,490	3,639,526
Office and general	425,822	184,459	757,829
Professional fees	443,593	433,821	1,114,341
Shareholder relations	367,902	119,621	524,204
Travel	158,585	33,425	245,237
	<u>30,913,748</u>	<u>16,684,465</u>	<u>57,956,211</u>
Net loss for the period before taxes	(29,768,904)	(16,529,412)	(56,585,347)
Future income tax recovery	<u>8,699,037</u>	<u>5,900,000</u>	<u>16,699,037</u>
Net loss for the year	(21,069,867)	(10,629,412)	(39,886,310)
Deficit, beginning of year	<u>(22,170,863)</u>	<u>(11,541,451)</u>	
Deficit, end of year	<u>(\$43,240,730)</u>	<u>(\$22,170,863)</u>	
Net loss per share (Note 10)	<u>(\$0.46)</u>	<u>(\$0.32)</u>	

The accompanying notes are an integral part of the financial statements

BAFFINLAND IRON MINES CORPORATION**(Development Stage Entity)****STATEMENTS OF CASH FLOWS****For the years ended,**

	2006	2005	Cumulative from January. 1 2003
Operating activities			
Loss for the year	(\$21,069,867)	(\$10,629,412)	(\$39,886,310)
Items not effecting cash:			
Amortization expense	94,990	11,956	113,393
Stock-based compensation	2,173,536	588,490	3,639,526
Future income tax recovery	(8,699,037)	(5,900,000)	(16,699,037)
Net capital deficiency on reverse take over transaction	-	-	(283,467)
Other non cash items	-	-	7,925
	<u>(27,500,378)</u>	<u>(15,928,966)</u>	<u>(53,107,970)</u>
Decrease in accounts receivable	(11,638)	(284,871)	(388,937)
Increase in prepaid expenses	(804,344)	(192,012)	(1,136,134)
Increase in accounts payable	1,975,353	425,711	2,669,565
	<u>(26,341,007)</u>	<u>(15,980,138)</u>	<u>(51,963,476)</u>
Investing activities			
Purchase of capital assets	(839,961)	(87,325)	(959,519)
Financing activities			
Decrease in due to related parties	(123,347)	-	(132,421)
Proceeds on issue of common shares and warrants	20,362,771	31,225,549	65,506,699
	<u>20,239,424</u>	<u>31,225,549</u>	<u>65,374,278</u>
(Decrease) increase in cash	(6,941,544)	15,158,086	12,451,283
Cash position at beginning of year	<u>19,392,827</u>	<u>4,234,741</u>	<u>-</u>
Cash position at end of year	<u>\$12,451,283</u>	<u>\$19,392,827</u>	<u>\$12,451,283</u>

The accompanying notes are an integral part of the financial statements

BAFFINLAND IRON MINES CORPORATION
(Development Stage Entity)
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED DECEMBER 31, 2006

1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Baffinland Iron Mines Corporation (the "Company") was formed pursuant to Articles of Amendment under the Business Corporation Act (Ontario) on February 6, 2004.

The Company has non-producing iron ore interests located on Baffin Island, Nunavut, Canada.

These financial statements have been prepared using Canadian generally accepted accounting principles ("Canadian GAAP") applicable to a going concern, which assumes continuity of operations and realization of assets and settlement of liabilities in the normal course of business. However, the Company is in the development stage and is subject to the risks and challenges similar to other companies in a comparable stage of development. These risks include, but are not limited to, dependence on key individuals, successful development and the ability to secure adequate financing to meet the minimum capital required to successfully complete the project and continue as a going concern. There is no assurance that these initiatives will be successful and as a result there may be substantial doubt regarding the going concern assumption. These financial statements do not reflect the adjustments to the carrying values of assets and liabilities and the reported expenses and balance sheet classifications that would be necessary were the going concern assumption inappropriate. These adjustments could be material.

2. SIGNIFICANT ACCOUNTING POLICIES

- a) The financial statements of the Company, which are expressed in Canadian dollars, have been prepared in accordance Canadian GAAP.
- b) **Basis of consolidation:**
Prior to November 24, 2005, the financial statements of the Company were consolidated to include PHM Corp., a Canadian wholly-owned subsidiary. PHM Corp. has been inactive since its incorporation and contained no assets or liabilities. On November 24, 2005, under Articles of Dissolution PHM Corp. was dissolved.
- c) **Cash and cash equivalents**
Cash and cash equivalents are highly liquid investments, such as term deposits with major financial institutions or government treasury bills, having a maturity of three months or less at the date of original issue.
- d) **Flow-through shares**
The Company has financed the majority of its exploration activities through the issuance of flow-through shares. Under the terms of the flow-through share agreements, the tax attributes of the related expenditures are renounced to subscribers. To recognize the foregone tax benefits to the Company, the carrying value of the shares issued is reduced by the tax effect of the tax benefits renounced to subscribers. The Company recognizes the foregone tax benefit at the time of the renouncement, provided there is reasonable assurance that the expenditures will be incurred.

NOTES TO THE FINANCIAL STATEMENTS (contd)

2. SIGNIFICANT ACCOUNTING POLICIES (contd)

e) **Mining interests and exploration expenditures:**

The Company expenses exploration expenditures as incurred. However, costs related to property acquisitions are capitalized. Development expenditures on the property will be capitalized once mineral reserves have been established. Development costs together with the cost of mining interests will be charged to operations on a units-of-production method based on estimated recoverable reserves. If the mining interests are abandoned, or if an impairment in asset values has been determined, the capitalized costs will be reduced to fair value through a charge to operations.

f) **Capital assets:**

Capital assets are carried at cost, less accumulated amortization. Amortization of capital assets is calculated on the following basis:

Exploration equipment	5 year straight line
Furniture & fixtures	5 year straight line
Leasehold improvements	5 year straight line
Computer equipment	30% declining balance

g) **Use of estimates:**

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reported period. These estimates are reviewed periodically, and as adjustments become necessary, they are made in the period in which they become known. Actual results could differ from these estimates.

h) **Income taxes:**

The Company accounts for income taxes in accordance with the liability method. Under the liability method, future income tax assets and liabilities are recognized for differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted income 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 income tax assets and liabilities of a change in income tax rates is recognized in the period that includes the date of substantive enactment. A future income tax asset is recognized only when it is more likely than not that the income tax asset will be realized.

i) **Accounting for stock-based compensation:**

Compensation expense is recognized in equal instalments over the vesting period of the options issued. The expense is determined using an option pricing model that takes into account the exercise price, the term of the options, the current stock price, the expected volatility of the underlying shares, the expected dividend yield and the risk free rate for the term of the option.

NOTES TO THE FINANCIAL STATEMENTS (contd)

2. SIGNIFICANT ACCOUNTING POLICIES (contd)

- j) **Fair value of financial instruments:**
The carrying value of cash and equivalents, accounts receivable, prepaid expenses, and accounts payable approximate their fair values due to their immediate or short term nature.
- k) **Impairment of long-term assets:**
The company reviews long-lived assets for impairment when events or circumstances indicate that the assets carrying amount may not be recoverable. When management determines that an impairment exists, the impairment loss will be established by comparing the assets carrying amount to its fair value, which is determined using a discounted cash flow model.
- l) **Asset retirement obligations:**
Future costs to retire an asset including dismantling, remediation and on-going treatment and monitoring of the site are recognized and recorded as a liability at fair value. The liability is accreted over time through periodic charges to earnings. The asset retirement costs are capitalized as part of the assets carrying value and amortized over the assets useful life.

At the present time, management has concluded that there are no asset retirement obligations associated with any of the Company's assets

3. CASH AND CASH EQUIVALENTS

	2006	2005
Cash and cash equivalents are comprised of:		
Cash	\$2,019,960	\$7,112,847
Restricted cash related to flow through share financings	10,431,323	12,279,980
	<u>\$12,451,283</u>	<u>\$19,392,827</u>

The Company has posted a \$500,000 Letter of Credit which is collateralized by cash. The Letter of Credit expires in October 2007 (see note 11).

4. MINING INTERESTS

The Company has a 100% interest in three mining leases in the Mary River area of Baffin Island, Nunavut, Canada. The term of the leases are 21 years and are due for renewal in 2013.

NOTES TO THE FINANCIAL STATEMENTS (contd)

5. CAPITAL ASSETS

Capital assets are comprised of:

	2006			2005		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Exploration equipment	\$715,593	\$ 54,370	\$661,223	\$ -	\$ -	-
Furniture & fixtures	39,816	21,993	17,823	33,463	14,403	19,060
Leasehold improvements	106,685	18,220	88,465	50,808	4,000	46,808
Computer equipment	97,425	18,810	78,615	35,287	-	35,287
	<u>\$959,519</u>	<u>\$ 113,393</u>	<u>\$846,126</u>	<u>\$ 119,558</u>	<u>\$ 18,403</u>	<u>\$ 101,155</u>

6. CAPITAL STOCK

Authorized: Unlimited common shares

Issued:

	Number of shares	Amount \$
December 31, 2004	25,760,987	12,454,882
Broker warrants - March & May, 2005	52,500	65,625
Share financing - private placement May, 2005 - net of financing expenses	1,806,443	2,377,785
- Flow through private placement May, 2005 - net of financing expenses	7,741,935	6,482,139 (i)
Share financing - private placement December, 2005	2,750,000	5,500,000
- flow through private placement December, 2005	<u>6,000,000</u>	<u>7,200,000 (ii)</u>
December 31, 2005	44,111,865	34,080,431
Share financing - flow through private placement September, 2006	2,000,000	3,250,000 (iii)
Share financing - flow through private placement October, 2006	<u>5,818,180</u>	<u>9,762,771 (iv)</u>
December 31, 2006	<u>51,930,045</u>	<u>47,093,202</u>

(i) Net future income tax liability of \$4,800,000 recorded on renunciation of flow through expenditures.

(ii) Net future income tax liability of \$4,800,000 recorded on renunciation of flow through expenditures.

(iii) Net future income tax liability of \$1,750,000 recorded on renunciation of flow through expenditures.

(iv) Net future income tax liability of \$5,600,000 recorded on renunciation of flow through expenditures.

Warrants

During 2005, warrants on 52,500 common shares were exercised for a total consideration of \$65,625. As at December 31, 2006 there are no warrants outstanding.

NOTES TO THE FINANCIAL STATEMENTS (contd)

6. CAPITAL STOCK (contd)

Contributed Surplus

Balance, December 31, 2004	\$ 1,887,497
Fair Value of options granted	<u>588,490</u>
Balance, December 31, 2005	2,475,987
Fair Value of options granted	<u>2,173,536</u>
Balance, December 31, 2006	<u>\$ 4,649,523</u>

7. STOCK-BASED COMPENSATION

Stock options

At a special meeting of shareholders held on January 15, 2004, approval was given to an incentive stock option plan. The Company can set aside up to 10% of its shares issued and outstanding at the time of granting of options to directors, officers, employees, management company employees or consultants. There is an 18 month vesting period for the options granted; 25% are available the day of the grant with a further 25% available on each six month anniversary of the grant. The terms of the awards under the plan are determined by the Board of Directors. The options granted to date have a five year term. Compensation expense and contributed surplus will be recognized when the options are granted to the extent of 25% with the remaining 75% being recognized equally over the remaining vesting period, which is the 18 month vesting period. Details of stock option grants during 2005 and 2006 to date are as follows:

Grant Date	Number of Options	Exercise Price	Expiry Date
March 11, 2005	646,000	\$2.30	March 10, 2010
July 5, 2005	190,000	\$1.18	July 4, 2010
October 13, 2005	50,000	\$1.50	October 12, 2010
January 3, 2006	611,000	\$2.15	January 2, 2011
January 27, 2006	300,000	\$2.75	January 26, 2011
July 10, 2006	205,000	\$1.99	July 9, 2011
December 15, 2006	946,000	\$2.60	December 16, 2011

During the year ended December 31, 2005, 75,000 common share options granted on March 11, 2005 were cancelled.

A summary of the status of the Company's stock option plan as at December 31, 2006 and changes during the year ended December 31, 2006 are presented in the following table:

	2006		2005	
	Number	Weighted Average	Number	Weighted Average
Outstanding, beginning	2,161,000	1.46	1,350,000	1.14
Granted	2,062,000	2.43	886,000	2.02
Exercised	-	-	-	-
Cancelled	-	-	(75,000)	2.30
Outstanding, ending	<u>4,223,000</u>	<u>1.93</u>	<u>2,161,000</u>	<u>1.46</u>

NOTES TO THE FINANCIAL STATEMENTS (contd)

7. STOCK-BASED COMPENSATION (contd)

As at December 31, 2006 stock options available for exercise is 2,844,250 at a weighted average price of \$1.74 and the aggregate unexpensed fair value of unvested stock options granted amounted to \$1,849,606

Stock option disclosure:

The fair market value of stock options granted was estimated using the Black Scholes fair value option-pricing model and the following assumptions were used:

Date options granted	Risk-free Interest rate	Expected Stock Volatility
March 11, 2005	4.25%	100.20%
July 5, 2005	4.25%	90.64%
October 13, 2005	4.50%	101.00%
January 3, 2006	5.00%	80.63%
January 27, 2006	5.00%	77.31%
July 10, 2006	6.00%	69.83%
December 15, 2006	6.00%	81.99%

No dividend yield is assumed and the weighted average expected life is 5 years for all stock options granted to date.

Option pricing models require the use of subjective estimates and assumptions including the expected stock price volatility. Changes to these estimates and assumptions may materially affect the calculations. Stock-based compensation calculations have no effect on the Company's cash position.

Using the fair value method, compensation expense for stock options issued and outstanding for the year ended December 31, 2006 was \$2,173,536 (2005 - \$588,490).

NOTES TO THE FINANCIAL STATEMENTS (contd)

8. INCOME TAXES

The Company's income tax provision (recovery) has been calculated as follows:

	<u>2006</u>	<u>2005</u>
Net loss for the year	(29,768,904)	(16,529,412)
Income tax recovery (provision) at Canadian federal and provincial statutory rates	(10,519,869)	(5,841,238)
Flow through share issuances	1,082,738	(271,957)
Permanent differences	768,094	213,195
Recovery of income taxes	<u>(8,669,037)</u>	<u>(5,900,000)</u>

The components of the recovery of income taxes comprise:

Current tax expense	-	-
Future income tax expense	<u>(8,669,037)</u>	<u>(5,900,000)</u>
Net income tax recovery	<u>(8,669,037)</u>	<u>(5,900,000)</u>

The components of the Company's future income tax assets and liabilities at December 31, 2006 and 2005 are summarized as follows:

	<u>2006</u>	<u>2005</u>
Future Income Tax Assets		
Exploration & Development	2,614,000	1,586,000
Non-capital losses carried forward	907,000	515,000
Other temporary differences	380,000	203,000
Net future income tax asset	<u>3,901,000</u>	<u>2,304,000</u>
Valuation Allowance	(3,901,000)	(2,304,000)
Net future income tax asset recorded	<u>-</u>	<u>-</u>
Future Income Tax Liabilities		
Flow through share issuance	(3,686,000)	(5,000,000)
Net future income tax liability	<u>(3,686,000)</u>	<u>(5,000,000)</u>

NOTES TO THE FINANCIAL STATEMENTS (contd)

8. INCOME TAXES (contd)

The Company has recorded a valuation allowance in respect of its Canadian losses and other attributes of \$3,901,000 (2005 - \$2,304,000) as of December 31, 2006 because management believes that the future income tax assets have not met the "more likely than not" recognition threshold.

As at December 31, 2006, the Company has available non-capital loss carry-forwards for Canadian federal and provincial tax purposes that will expire as follows:

	<u>2006</u>	<u>2005</u>
2009	3,000	3,000
2010	51,000	51,000
2014	525,000	525,000
2015	879,000	879,000
2026	1,359,000	-

9. RELATED PARTY TRANSACTIONS

Due to related parties as at December 31, 2006 was nil (2005 - \$123,347). This liability was repaid during the year. The related parties consisted of two individuals who are directors and shareholders of the Company. This amount was carried forward on the purchase of control of Baffinland Iron Mines Limited by these individuals.

During 2006 the Company recovered \$72,000 in lease and operating costs from a related party.

A company controlled by a director and a shareholder charged the Company an administrative fee and salaries amounting to nil for the year ended December 31, 2006 (2005 - \$157,500). This amount was paid as an administrative fee which included rent, accounting, corporate, and office services incurred in the normal course of business at market rates. The contract to provide these services ended on August 31, 2005.

10. NET LOSS PER SHARE

Net loss per share is calculated using the weighted average number of common shares outstanding during the period. No effect has been given to the potential exercise of stock options in the calculation of fully diluted loss per share as the effect would be anti-dilutive. The weighted average number of common shares outstanding December 31, 2006 amounted to 45,788,577 (2005 - 31,611,979)

NOTES TO THE FINANCIAL STATEMENTS (contd)

11. CONTINGENCIES AND COMMITMENTS

Under the terms of existing lease agreements for office space, the Company is committed to annual lease payments of approximately \$92,400 plus operating costs. During 2006 the company paid approximately \$240,000 in lease and operating costs. The lease agreement has an initial five year term and includes a one time right to renew the lease. As at December 31, 2006, there is three years and eight months remaining on the initial term of the lease.

The Company signed a letter of intent in July 2006 with a construction company which is engaged to upgrade the Mary River road. The Company is committed to pay \$946,514 (approximately \$670,000 outstanding at December 31, 2006) over a nine month period ending March 31, 2007, \$1,820,500 over the twelve month period ending March 31, 2008 and \$1,906,476 over the five month period ending August 31, 2008.

The Company signed a letter of intent in December 2006 with a manufacturing company engaged to supply and install turnkey fuel tank farms for the Mary River Project. The Company made an initial deposit of \$687,230 and is committed to pay \$1,883,518 in January 2007 and \$2,570,748 over an eight month period ending August 2007.

The Company has entered into an agreement with a contractor to mine a bulk sample. If the Company does not proceed with mining the bulk sample, the Company will be required to purchase trucks ordered by the mining contractor with an aggregate value of approximately \$2,700,000. The truck manufacturer has agreed to, on a best efforts basis, assist in the sale of any trucks the Company does not want to purchase. An initial \$300,000 deposit was provided to the mining contractor who has ordered the long-lead time equipment. The deposit will be deducted from the first mining invoice received.

The Company has signed a fuel drum storage agreement with the Government of Nunavut ("GON") that allows the company to store fuel in an approved storage facility. Baffinland has provided a \$500,000 irrevocable letter of credit to the GON which provides insurance against an event of a release or spill from the Petroleum Products being stored (see note 3).

12. COMPARATIVE FIGURES

On the Statement of Operations the 2005 categorization of expenses, where necessary, have been reclassified to conform with the current year presentation.