Lucara Diamond Corp.

# MD&A and Consolidated Financial Statements

## Year Ending: December 31, 2013

# LUCARA DIAMOND CORP.
# MANAGEMENT'S DISCUSSION AND ANALYSIS
# DECEMBER 31, 2013

Management's discussion and analysis ("MD&A") focuses on significant factors that have affected Lucara Diamond Corp. (the "Company") and its subsidiaries performance and such factors that may affect its future performance. In order to better understand the MD&A, it should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2013, which are prepared in accordance with International Financial Reporting Standards ("IFRS" as issued by the International Accounting Standards Board ("IASB"). All amounts are expressed in U.S. dollars unless otherwise indicated. The effective date of this MD&A is February 20, 2014.

Some of the statements in this MD&A are forward-looking statements that are subject to risk factors set out in the cautionary note contained herein.

Additional information about the Company and its business activities is available on SEDAR at www.sedar.com.

## HIGHLIGHTS

**Safety:** There were no Lost Time Injury ("LTI's") and no reportable environmental incidents at Karowe during the fourth quarter of 2013. Karowe's full year Lost Time Injuries Frequency Rate ("LTIFR") was 0.17. LTIFR is defined as the total number of work hours lost per 200,000 work hours.

**Cash flows, cash operating margins and year end diamond inventory**: The Company achieved revenue of $47.9 million ($433 per carat) from sales of 110,635 carats of diamond during the fourth quarter of 2013 including one exceptional stone tender. This excludes revenue of $10.9 million, which was received during the quarter from Karowe's late September tender. At an average operating expense of $109 per carat, the cash operating margin during the quarter was $324 per carat.

Full year sales of 438,717 carats achieved proceeds of $180.5 million, or $411 per carat. The Company achieved a full year cash operating margin of $311 per carat based on operating expenses of $100 per carat. Full year operating cost per tonne milled was $18 compared to budget of $23 per tonne. Attention to cost control and the revenues from exceptional stone tenders have resulted in the Company achieving a full year earnings before deducting interest and other financial charges, income taxes, depreciation and amortization ("EBITDA" see page 7 Non-IFRS measures) of $102.9 million in its first full year of operations.

At year end the Company was well positioned for 2014 with a significant diamond inventory of approximately 67,000 carats of diamond, including a selection of exceptional stones totalling over 1,000 carats. The Company expects to hold its first Exceptional Stone Tender of 2014, early in the second quarter.

**Exceptional stone tenders:** The Company continued to recover large and exceptional diamonds, resulting in an exceptional stone tender during the quarter achieving revenue of $22.9 million ($20,280 per carat). During 2013 the Company held three exceptional stone tenders achieving revenues of $72.1 million (2,971 carats at $24,290 per carat).

**Net cash position:** The Company continued to achieve strong cash operating earnings of $39.0 million during the quarter and $118.6 million for the year resulting in a year-end cash balance of $49.4 million. Management expects to use the existing cash resources to finance Karowe's plant upgrade capital expenditure during 2014. At year-end the Company remains debt free with the $25 million Scotiabank credit facility being undrawn.

**Karowe operating performance:** Karowe exceeded budget in terms of carats recovered and sold and surpassed its initial and updated revenue forecast of $90 million and $118 million respectively due largely to the recovery of its large and exceptional diamonds.

## FINANCIAL HIGHLIGHTS

| *In millions of U.S. dollars unless otherwise noted* | **Three months ended December 31 2013** | 2012 | **Year Ended December 31 2013** | 2012 |
|---|---|---|---|---|
| Revenues | $ 58.7 | $ 29.1 | $ 180.5 | $ 41.8 |
| Proceeds from quarterly sales tenders is comprised of: | | | | |
| Sales proceeds received during the period | 47.8 | 29.1 | 180.5 | 41.8 |
| September tender proceeds received in October | 10.9 | - | - | - |
| Total proceeds from quarterly sales tenders | 58.7 | 29.1 | 180.5 | 41.8 |
| Average price per carat sold (excluding September tender proceeds received in October) | 433 | 289 | 411 | $274 |
| Operating expenses per carat sold | 109 | 84 | 100 | 92 |
| Cash operating margin per carat | 324 | 205 | 311 | 182 |
| Net income (loss) for the period | 21.3 | (4.1) | 65.2 | (7.5) |
| Income (loss) per share | 0.05 | (0.01) | 0.17 | (0.02) |
| Cash flow from operations (before working capital adjustments) | 33.9 | 3.8 | 99.6 | (3.8) |
| Cash on hand | 49.4 | 13.3 | 49.4 | 13.3 |

## OUTLOOK

This section of the MD&A provides management's production and cost estimates for 2014. These are "forward-looking statements" and subject to the cautionary note regarding the risks associated with forward-looking statements.

### *Karowe Mine, Botswana*

Karowe is forecast to process 2.2-2.4 million tonnes of ore and to produce and sell 400,000 to 420,000 carats of diamond in 2014. Revenue is forecast between $150 - $160 million.

Ore mined is forecast between 3.0 – 3.5 million tonnes and waste mined is expected to be between 10.0 – 11.0 million tonnes.

Karowe's operating cash costs (see page 7 Non-IRFS measures) are expected to be between $31-$33 per tonne ore treated.

Capital expenditures include between $45-$50 million for Karowe's plant upgrade to improve large diamond recovery following the occurrence of exceptional stones, and to enable sustainable processing of hard ore in the south lobe. Sustaining capital expenditures is forecast at $3.5 million.

The Company plans on holding eight diamond tenders and two exceptional stone tenders during the year. The timing of these tenders will be based on Karowe's production profile as well as commercial decisions to maximize diamond revenue.

Karowe's detailed operating performance and capital spend guidance is available on SEDAR at www.sedar.com.

## BUSINESS OVERVIEW

The Company is a diamond mining company focused in Africa. The business of the Company consists of the acquisition, exploration, development and operation of diamond properties. The Company's head office is in Vancouver, BC, Canada and its common shares trade on the Toronto Stock Exchange, the NASDAQ OMX First North in Sweden and the Botswana Stock Exchange under the symbol "LUC".

The principal assets of the Company and the focus of the Company's operations, development and exploration activities are on assets in Lesotho and Botswana.

The following summarizes the Company's current land holdings:

| Country | Name | Interest Held | Area ($km^2$) |
|---|---|---|---|
| Botswana | Karowe Diamond License | 100% | 15.3 |
| Lesotho | Mothae Diamond Mining Lease | 75% | 20.0 |

## RESULTS OF OPERATIONS

### *Karowe Mine, Botswana*

| | UNIT | Q4-13 | Q3-13 | Q2-13 | Q1-13 | Q4-12 |
|---|---|---|---|---|---|---|
| **Sales** | | | | | | |
| Revenues | US$m | 58.7 | 42.1 | 47.2 | 32.5 | 29.1 |
| Proceeds generated from sales tenders conducted in the quarter are comprised of: | US$m | 47.8 | 50.9 | 49.3 | 32.5 | 29.1 |
| Sales proceeds received during the quarter | US$m | 58.7 | 42.1 | 47.2 | 32.5 | 29.1 |
| September tender proceeds received in October | US$m | (10.9) | 10.9 | - | - | - |
| Sales proceeds received post June period end | US$m | - | (2.1) | 2.1 | - | - |
| Carats sold for proceeds generated during the period | Carats | 110,635 | 80,918 | 102,452 | 144,712 | 100,987 |
| Carats sold for revenues recognized during the period | Carats | 127,804 | 76,582 | 89,619 | 144,712 | 100,987 |
| Average price per carat for proceeds generated during the period | US$ | 433 | 625 | 481 | 225 | 289 |
| **Production** | | | | | | |
| Tonnes mined (ore) | Tonnes | 918,765 | 898,501 | 1,157,747 | 969,330 | 701,931 |
| Tonnes mined (waste) | Tonnes | 1,694,134 | 1,430,105 | 1,259,479 | 1,109,727 | 1,267,343 |
| Tonnes milled | Tonnes | 613,064 | 647,304 | 560,910 | 533,260 | 545,354 |
| Average grade processed | cpht (*) | 18.9 | 17.6 | 15.6 | 23.1 | 25.4 |
| Carats recovered | Carats | 116,061 | 113,882 | 87,580 | 123,228 | 138,487 |
| **Costs** | | | | | | |
| Operating costs per carats sold (see page 7 Non-IRFS measures) | US$ | 109 | 110 | 102 | 86 | 84 |
| Capital expenditures | US$m | 1.5 | 2.4 | 1.7 | 2.2 | 0.4 |

(*) carats per hundred tonnes

Operational performance at Karowe was as per forecast for the last quarter of 2013. Tonnes of ore mined were on target, and overall waste stripping was well advanced to access the deeper sections of the ore body in the south lobe as per the life of mine plan. The mine currently has three months of ore exposed providing flexibility of material processed. The process plant performed well during the quarter, and tonnes processed and carats produced were in line with forecast.

The first full year of operations at Karowe was very successful with production and cost targets either being met or exceeded. The 2013 year end target of 440,000 carats recovered was surpassed.

The frequency of special stones (+10.8 carats) recovered during the quarter was significant with 190 stones recovered with an average size of over 26 carats. This included five stones of over 100 carats and a single 281 carat stone. The recovery of specials during 2013 far exceeded expectations with 732 specials recovered with a total weight of over 18,000 carats equating to 4% of annual production. Included in this were 17 stones over 100 carats and 4 stones over 200 carats.

The geological resource update was completed during the quarter, which demonstrated superior value through the recognition of a continued presence of exceptional stones within the centre and south lobes. This is now reflected in the size frequency distributions and an increase in average modeled price to $394 per carat for an indicated mineral resource of 46.2 million tonnes with an average grade of 16 carats per hundred tonnes. The NI43-101 technical report accompanying the resource update was published on February 3, 2014 and can be found at www.sedar.com.

## REVIEW OF PROJECTS

### *Mothae Diamond Project, Lesotho*

The Mothae project is located in northeast Lesotho and is a large low grade kimberlite containing a population of large, high value Type IIa diamonds.

The Company is currently reviewing a number of development options for Mothae.

*Karowe, Plant Optimization Project*

Karowe's plant optimization project to modify the process plant to treat the harder material at depth and improve the recovery of exceptional diamonds is advancing. Orders have been completed for some long lead items, and the project schedule is on track to be complete by year end.

## SELECT ANNUAL FINANCIAL INFORMATION

| | | | | | | **Year ended December 31,** |
|---|---|---|---|---|---|---|
| *In millions of U.S. dollars unless otherwise noted* | | **2013** | | **2012** | | **2011** |
| Revenues | $ | 180.5 | $ | 41.8 | $ | - |
| Operating expenses | | (43.8) | | (14.0) | | - |
| Royalty expenses | | (18.1) | | (4.2) | | - |
| **Cash operating earnings** [(1)] | | **118.6** | | 23.6 | | - |
| Exploration and other mining costs | | (1.3) | | (12.8) | | (6.6) |
| Administration | | (11.4) | | (9.5) | | (8.2) |
| Gain on sale of exploration program diamonds | | 0.5 | | - | | 2.3 |
| Sales and marketing | | (3.5) | | (1.5) | | - |
| **EBITDA** [(2)] | | **102.9** | | (0.2) | | (12.5) |
| Depletion, amortization and accretion | | (15.0) | | (5.9) | | - |
| Finance income (expenses) | | (3.8) | | (3.1) | | (1.9) |
| Foreign exchange gain (loss) | | (3.9) | | 1.7 | | (4.3) |
| Income tax expense | | (15.0) | | - | | - |
| **Net income (loss) for the year** | | **65.2** | | (7.5) | | (18.7) |
| | | | | | | |
| **Total equity** | | **202.9** | | 157.5 | | 170.4 |
| **Cash flow from operations (before working capital adjustments)** | | **99.6** | | 3.8 | | (11.7) |
| **Total assets** | | **247.2** | | 235.4 | | 241.3 |
| **Cash on hand** | | **49.4** | | 13.3 | | 48.6 |
| **Income (loss) per share (basic and diluted)** | | **0.17** | | (0.02) | | (0.05) |
| | | | | | | |
| **Per carat sold** | | | | | | |
| **Sales price** | **$** | **411** | $ | 274 | | - |
| **Operating expenses** | | **100** | | 92 | | - |

(1) Cash operating earnings is a non-IFRS measure (page 7) defined as sales less operating expenses and royalty expenses.
(2) EBITDA is a non-IFRS measure (page 7) defined as earnings before interest, taxation, depreciation and amortization.

### *Revenues*

During the year the Company had sales totalling 438,717 carats for gross proceeds of $180.5 million at an average price of $411 per carat. The increase in revenues of $138.7 million compared to the prior year is due to a full year's production and the corresponding sales as well as the sale of large exceptional stones, which contributed $72 million to revenues. In 2012 the Company commenced production and declared commercial production at Karowe as at July 1, 2012.

### *Cash operating earnings*

Cash operating earnings for the year ended December 31 2013 were $118.6 million resulting in a cash operating margin (before royalties) of 76%. Full year operating expenses at $100 per carat resulted in a cash operating margin of $311 per carat.

Cash operating earnings is a non-IFRS measure and is reconciled in the table above.

### *Exploration and other mining costs*

Exploration expenditures and other mining costs relating to the Mothae project were $1.3 million during 2013 compared to $12.8 million in 2012. The decrease is due to Mothae being on care and maintenance during the year compared to the previous year when the Company was completing its trial mining program.

### *Administration expenses*

Administration expenses were $11.4 million in 2013 compared to $9.5 million in 2012. The increase of $1.9 million was due largely to accrued employee performance payments, higher professional fee expenditures due to the preparation of the Company's resource update and contribution to the Lundin Foundation.

### *Income Tax expense*

Income tax expense was $15.0 million during the year. This is mainly due to the recognition of a deferred tax liability during the year, which resulted in a corresponding non-cash future income tax expense of $14.9 million. The deferred tax liability relates to temporary differences between the accounting and tax base of the Company's property, plant and equipment, restoration provisions and non-capital tax loss pools. The Company has applied a significant portion of its non-capital losses in Botswana against taxable income during the year.

### *Earnings before interest, tax, depreciation and amortization (EBITDA)*

Full year EBITDA was $102.9 million compared to a loss in the previous year of $0.2 million. This increase was due to an additional 285,993 carats sold during the year, including three exceptional stone tenders achieving $72.1 million and lower exploration costs following Mothae being placed on care and maintenance during 2013.

EBITDA is a non-IFRS measure and is reconciled in the table above.

## LIQUIDITY AND CAPITAL RESOURCES

As at December 31, 2013, the Company had cash of $49.4 million compared to cash of $13.3 million at December 31, 2012 and $33.6 million at September 30, 2013. The December sale's royalty payment was not paid until January 2014.

Cash generated from operating activities before working capital movements for the year ended December 31, 2013 was an inflow of $99.6 million. These proceeds were offset by the Company's repayment of its $50 million debenture as well as repayment of the outstanding balance of the Company's revolving credit facility of $4.5 million. In addition, the Company incurred capital expenditures of $7.9 million, which includes payment of $2.9 million for project retentions during the year, which had been previously accrued.

In April 2012, the Company signed a definitive agreement with the Bank of Nova Scotia for a $25 million revolving term credit facility with a maturity date of March 26, 2014, which may be extended if both parties agree.

The facility contains financial and non-financial covenants customary for a facility of this size and nature. As at December 31, 2013 and to date, the Company was in compliance with all financial and non-financial covenants. The applicable interest rate of any loan advances under the facility will be determined by the Company's leverage ratio at that time. The Company has provided security on the two year facility by way of a charge over the Company's Karowe assets and a guarantee by the Company's subsidiaries, which hold the Karowe assets. As at December 31, 2013 the full amount under this facility was available.

## SUMMARY OF QUARTERLY RESULTS

(All amounts expressed in thousands of U.S. dollars, except per share data)

The Company's financial statements are reported under IFRS issued by the IASB. The following table provides highlights, extracted from the Company's financial statements, of quarterly results for the past eight quarters (unaudited):

| Three months ended | Dec-13 | Sept-13 | Jun-13 | Mar-13 | Dec-12 | Sept-12 | Jun-12 | Mar-12 |
|---|---|---|---|---|---|---|---|---|
| A. Revenues | 58,683 | 42,096 | 47,224 | 32,504 | 29,172 | 12,658 | Nil | Nil |
| B. Exploration (expenditures) recovery | (167) | (389) | (557) | 374 | (2,277) | (4,465) | (2,798) | (3,314) |
| C. Administration expenses | (4,871) | (1,851) | (2,761) | (1,946) | (1,798) | (2,980) | (3,392) | (1,364) |
| D. Net income (loss) | 21,331 | 15,043 | 22,679 | 6,169 | 7,664 | (3,413) | (7,606) | (4,170) |
| E. Earnings (loss) per share (basic and diluted) | 0.05 | 0.04 | 0.06 | 0.02 | 0.02 | (0.01) | (0.02) | (0.01) |

### *Revenues*

During the three months ended December 31, 2013, the Company completed three diamond tenders, one of which was an exceptional diamond tender. The exceptional diamond tender generated gross proceeds of $22.9 million or $20,280 per carat. The tenders achieved winning bids totalling $47.8 million or $433 per carat. During the three months ended December 31, 2013, the Company received proceeds of $10.9 million (17,642 carats) from tenders completed in the previous quarter, which had not been collected at the end of the third quarter and therefore this revenue has have been recognized during the current period in the Company's consolidated statement of operations.

### *Exploration and other mining costs*

Exploration expenditures and other mining costs relating to the Mothae project were $0.2 million during the fourth quarter of 2013 compared to $1.3 million during the fourth quarter of 2012. The decrease in costs follows Mothae being placed on care and maintenance.

### *Administration expenses*

Administration expenses increased $3.0 million during the quarter when compared to the previous three month period due largely to accrued employee performance payments, higher professional fee expenditures due to the preparation of the Company's resource update and contribution to the Lundin Foundation of $0.3 million for social programs in Botswana and Lesotho.

## NON-IFRS FINANCIAL MEASURES

This MD&A refers to certain financial measures, such as cash operating earnings and EBITDA, which are not measures recognized under IFRS and do not have a standardized meaning prescribed by IFRS. These measures may differ from those made by other corporations and accordingly may not be comparable to such measures as reported by other corporations. These measures have been derived from the Company's financial statements, and applied on a consistent basis, because the Company believes they are of assistance in the understanding of the results of operations and financial position.

Cash operating earnings (see "Select Annual Financial Information") is the term the Company uses to describe the cash that is generated from sales net of cost of goods sold, excluding depletion, amortization and accretion, and excluding the effect of changes in working capital.

EBITDA (see "Select Annual Financial Information") is the term the Company uses as an approximate measure of the Company's pre-tax operating cash flow and is generally used to better measure performance and evaluate trends of individual assets. EBITDA comprises earnings before deducting interest and other financial charges, income taxes, depreciation and amortization and net loss attributable to non-controlling interests.

Operating costs per carats sold (see "Karowe Mine, Botswana") is the term the Company uses to describe the mining, processing and site administration costs to produce a single carat of diamond. This is calculated as operating costs per carat of diamond sold.

## RELATED PARTY TRANSACTIONS

During the year ended December 31, 2013, the Company incurred the following expenses with Namdo Management Services Limited ("Namdo") and Mile High Holdings Ltd. ("Mile High"), companies related by way of directors in common. The Company also incurred professional geological services and laboratory related expenditures from the Mineral Services Group ("MS Group"), a company that is associated with a former director of Company. Beginning July 1, 2013, the MS Group is no longer a related party.

*(All amounts expressed in thousands of U.S. dollars)*

| Description of services | Related Party | December 31, 2013 | December 31, 2012 |
|---|---|---|---|
| Management fees | Namdo | $ 489 | $ 504 |
| Donations | Lundin Foundation | 253 | - |
| Exploration related expenditures | MS Group | 84 | 1,916 |
| Aircraft charter | Mile High | 71 | 382 |
| | | $ 897 | $ 2,802 |

## FINANCIAL INSTRUMENTS

Financial assets and liabilities have been classified into categories that determine their basis of measurement and, for items measured at fair value, whether changes in fair value are recognized in the consolidated statements of operations or consolidated statements of comprehensive loss. Those categories are: fair value through profit or loss; loans and receivables; available for sale assets; and, for liabilities, amortized cost.

The fair value of the Company's available for sale financial instruments is derived from quoted prices in active markets for identical assets. The fair value of the Company's long-term debt approximates their carrying amounts due to the fact that there have been no significant changes in the Company's own credit risk. The fair value of all other financial instruments of the Company approximates their carrying values because of the demand nature or short-term maturity of these instruments.

In the normal course of business, the Company is inherently exposed to currency and commodity price risk. For a discussion of certain risks and assumptions that relate to the use of derivatives, including equity market risk, liquidity risk and credit risk, refer to Note 21 in the Company's consolidated financial statements. For a discussion of the methods used to value financial instruments, as well as any significant assumptions, refer also to Note 21 of the Company's consolidated financial statements.

## OUTSTANDING SHARE DATA

As at the date of this MD&A, the Company had 376,899,415 common shares outstanding and 4,208,334 stock options outstanding under its stock-based incentive plan. As at the same date, the Company had no stock purchase warrants outstanding.

## SUBSEQUENT EVENTS

### *Sale of Mothae plant*

In December 2013, the Company signed a memorandum of understanding ("MOU") with Paragon Diamonds Ltd. ("Paragon") for the sale of certain kimberlite processing plant and diamond recovery assets. Under the terms of the MOU, the Company will receive consideration of:

- $0.1 million cash and 4,434,589 common shares of Paragon on signing of the asset purchase agreement
- $0.2 million cash and 5,543,236 common shares of Paragon on commencement of relocation of the assets from the Mothae site. The number of common shares will be adjusted should an equity raise be completed by Paragon at a price less than £0.04.

The signing of the asset purchase agreement is anticipated by the end of February 2014.

As part of the MOU, the Company received a non-refundable deposit of US$50,000 from Paragon in December 2013.

### *Litigation*

Upon completion of the African Diamonds PLc ("AFD") Arrangement Agreement which resulted in the Company holding an undivided 100% ownership interest in the Karowe Mine, the Company retained certain liabilities related to legal proceedings initiated by two former directors of AFD against AFD alleging entitlement to a 3% NSR on production from the Karowe Mine. The claim was heard in the Botswana High Court in early June 2011. The High Court delivered its ruling in August 2011 dismissing the claims against AFD, with costs awarded against the plaintiffs.

In September 2011, the Company was notified that the plaintiffs, in the legal proceedings initiated against AFD, had filed an appeal of the decision of the High Court of Botswana dismissing the plaintiff's claims with costs awarded in favor of AFD. The appeal was heard in the Appeal Court of Botswana in January 2014 and judgment was handed down in February 2014.

The Court of Appeals, the highest court in Botswana upheld the previous ruling by the Botswana High Court, dismissing the claim against African Diamonds, with costs awarded against the plaintiffs. The decision is final and there is no further recourse against African Diamonds.

**RISKS AND UNCERTAINTIES**

The operations of the Company are speculative due to the high risk nature of its business which includes acquisition, financing, exploration, development and operation of diamond properties. Material risk factors and uncertainties, which should be taken into account in assessing the Company's activities, include, but are not necessarily limited to, those set below. Any one or more of these risks and others could have a material adverse effect on the Company.

***Diamond Prices and Marketability***

The mining industry, in general, is intensely competitive and there is no assurance that, a profitable market will exist for the sale of diamonds produced. The value of the Company's shares, its financial results and its mining activities are significantly affected by the price and marketability of diamonds. Numerous factors beyond the control of the Company may affect the price and marketability of any diamonds produced which cannot be accurately predicted, such as international economic and political trends, global or regional consumption and demand and supply patterns, increased production of other diamond producers, especially due to the small concentration of producers and sellers within the market. There is no assurance that the sale price of diamonds produced from any diamond deposit will be such that they can be mined at a profit.

***Economic Conditions***

Unfavourable economic conditions may negatively impact the Company's financial ability. Unfavourable economic conditions could also increase the Company's financing costs, decrease estimated income from prospective mining operations, limit access to capital markets and negatively impact the availability of credit facilities to the Company.

***Uncertainties Related to Mineral Resource Estimates***

There is a high degree of uncertainty attributable to the calculation of mineral resources and corresponding grades being mined or dedicated to future production. Until resources are actually mined and processed, no assurance can be given to the actual quantity of mineral resources and grades. Any material change in the quantity of resources, grades or stripping ratio may affect the economic viability of the Company's properties. In addition, there is no assurance that recoveries in small-scale laboratory tests will be duplicated in larger-scale tests under on-site conditions, or during production. Determining the economic viability of a diamond project is complicated and involves a number of variables. It involves extensive geo-statistical analysis due to the highly variable nature of diamond distribution in Kimberlite pipes and the fact that both diamond grade and average diamond value play important roles in determining the viability of any given diamond project. Since no two diamonds are exactly alike, a significant parcel of diamonds is needed to gain confidence levels on diamond size distribution and average diamond value necessary to make any realistic decisions regarding future development.

***Licenses, permits and approvals***

The Company's operations require licenses, permits and approvals from various governmental authorities. The Company believes that it currently holds and is presently complying in all material respects with all necessary licenses and permits under applicable laws and regulations to conduct its current operations. However, such licenses and permits are subject to change in various circumstances and certain permits and approvals are required to be renewed from time to time. Additional permits or permit renewals will need to be obtained in the future. The granting, renewal and continued effectiveness of these permits and approvals are, in most cases, subject to some level of discretion by the applicable regulatory authority. Certain governmental approval and permitting processes are subject to public comment and can be appealed by project opponents, which may result in significant delays or in approvals being withheld or withdrawn.

There can be no guarantee the Company will be able to obtain or maintain all necessary licenses and permits as are required to explore and develop its properties, commence construction or operation of mining facilities and properties under exploration or development or to maintain continued operations that economically justify the cost.

### *Currency Risk*

Currency fluctuations may impact the Company's financial performance. Diamonds are sold in US dollar with a majority of the Company's costs and expenses being incurred in Botswana Pula, South African Rand, Lesotho Loti, Canadian and U.S. dollar currencies. As a consequence, fluctuations in exchange rates may have a significant effect on the cash flows and operating results of the Company in either a positive or negative direction. In order to mitigate foreign exchange fluctuations the Company has hedged a proportion of its Botswana pula costs for the 2014 financial year.

### *Mining and Processing*

The Company's business operations are subject to risks and hazards inherent in the mining industry, including, but not limited to, unanticipated variations in grade and other geological problems, water, power, surface conditions, metallurgical and other processing problems, mechanical equipment performance problems, the lack of availability of materials and equipment, the occurrence of accidents, labour force disruptions, force majeure factors, weather conditions, which can materially and adversely affect among other things production quantities and rates, development, costs and expenditures and production commencement dates.

The Company periodically reviews its Life of Mine ("LOM") planning. Significant changes in the LOM plans can occur as a result of experience obtained in the course of carrying out its mining activities, changes in mining methods and rates, process changes, investments in new equipment and technology, diamond price assumptions and other factors. Based on this analysis, the Company reviews its accounting estimates and in the event of an impairment may be required to write down the carrying value of its mine or development property. This process continues for the economic life of the mines in which the Company has an interest.

### *Environmental and Other Regulatory Requirements*

All phases of mining and exploration operations are subject to government regulation including regulations pertaining to environmental protection. Environmental legislation is becoming stricter, with increased fines and penalties for non-compliance, more stringent environmental assessments of proposed projects and heightened responsibility for companies and their officers, directors and employees. There can be no assurance that possible future charges in environmental regulation will not adversely affect the Company's operations. As well, environmental hazards may exist on a property in which the Company holds an interest which were caused by previous or existing owners or operators of the properties and of which the Company is not aware at present. Operations at the Company's mines are subject to strict environmental and other regulatory requirements, including requirements relating to the production, handling and disposal of hazardous materials, pollution controls and health and safety. Any failure to comply with the requirements could result in substantial fines, delays in production, or the withdrawal of the Company's mining licenses.

### *Foreign Operations Risk*

The Company's current significant projects are located in Botswana and Lesotho. Each of these countries exposes the Company to risks that may not otherwise be experienced if its operations were domestic. The risks include, but are not limited to, environmental protection, land use, water use, health safety, labor, restrictions on production, price controls, currency remittance, and maintenance of mineral tenure and expropriation of property. For example, changes to regulations in Botswana and Lesotho relating to royalties, allowable production, importing and exporting of diamonds and environmental protection, may result in the Company not receiving an adequate return on investment capital.

Although the operating environments in Botswana and Lesotho are considered favorable compared to those in other developing countries, there are still political risks. These risks include, but are not limited to terrorism, hostage taking, military repression, expropriation, extreme fluctuations in currency exchange rates, high rates of inflation and labour unrest. Changes in mining or investment policies or shifts in political attitudes in these countries may also adversely affect the Company's business. In addition, there may be greater exposure to a risk of corruption and bribery (including possible prosecution under the federal Corruption of Foreign Public Officials Act). Also, in the event of a dispute arising in foreign operations, the Company may be subject to the exclusive jurisdiction of foreign courts and may be hindered or prevented from enforcing its rights. There is no assurance that future changes in taxes in any of the countries in which the Company operates will not adversely affect the Company's operations.

***Mineral Exploration and Development***

The business of exploring for diamonds and mining is highly speculative in nature and involves significant financial and other risks which even careful evaluation, experience and knowledge may not eliminate. There is no certainty that expenditures made or to be made by the Company in exploring and developing diamond properties in which it has an interest will result in the discovery of commercially mineable deposits. Most exploration projects do not result in the discovery of commercially mineable deposits. While discovery of a diamond bearing deposit may result in substantial rewards, few properties, which are explored are ultimately developed into producing mines. Major expenses may be required to establish reserves by drilling and to construct mining and processing facilities at a site. There can be no guarantee that exploration programs carried out by the Company will result in the development of profitable mining operations.

***Title Matters***

Any changes in the laws of Botswana or Lesotho relating to mining could have a material adverse effect to the rights and title to the interests held in those countries by the Company. No assurance can be given that applicable governments will not revoke or significantly alter the conditions of applicable exploration and mining authorizations nor that such exploration and mining authorizations will not be challenged or impugned by third parties.

***Infrastructure***

The Karowe Mine and the Mothae Project are located in remote areas and the availability of adequate infrastructure is critical. Reliable roads, bridges, power and water supply are important determinants, which affect capital and operating costs. Sabotage, government or other interference in the maintenance of provision of such infrastructure could adversely affect activities and profitability of the Company.

***Rehabilitation Funds and Mine Closure Costs***

Changes in environmental laws and regulations can create uncertainty with regards to future rehabilitation costs and affect the funding requirements. Closing a mine can have significant impact on local communities and site remediation activities may not be supported by local stakeholders. Actual costs realized in satisfaction of mine closure obligations may vary materially from management's estimates.

***Community Relations***

The Company's relationships with the communities in which it operates and other stakeholders are critical to ensure the future success of its existing operations and the construction and development of its projects. There is an increasing level of public concern relating to the perceived effect of mining activities on the environment and on communities impacted by such activities. Publicity adverse to the Company's operations, or the mining industry generally, could have an adverse effect on the Company and may impact relationships with the communities in which the Company operates and other stakeholders. While the Company is committed to operating in a socially responsible manner, there can be no assurance that its efforts in this respect will mitigate this potential risk.

***Uninsured Risks and Insurance Coverage***

The mining business is subject to a number of risks and hazards that may not be insured including, but not limited to, environmental hazards, industrial accidents, labour disputes, encountering unusual or unexpected geologic formations or other geological or grade problems, encountering unanticipated ground or water conditions, cave-ins, pit wall failures, flooding, rock bursts, periodic interruptions due to inclement or hazardous weather conditions and other acts of God. Such risks could result in damage to mineral properties or facilities, personal injury or death, environmental damage, delays in exploration, development or mining, monetary losses and possible legal liability.

The Company maintains insurance against certain risks that are associated with its business in amounts that it believes to be reasonable at the current stage of operations. There can be no assurance that such insurance will continue to be available at economically acceptable premiums or will be adequate to cover any future claim.

***Competition***

The mining industry is intensely competitive in all its phases and the Company competes with other companies that have greater financial resources and technical capacity. Competition could adversely affect the Company's ability to acquire prospective properties in the future.

***Current and Future Legal Proceedings***

Due to the nature of its business, the Company may be subject to numerous regulatory investigations, claims, lawsuits and other proceedings in the ordinary course of its business. The results of these legal proceedings cannot be predicated with certainty due to the uncertainty inherent in litigation, including the effects of discovery of new evidence or advancement of new legal theories, the difficulty of predicting decisions of judges and juries and the possibility that decisions may be reversed on appeal. There can be no assurance that these matters will not have a material adverse effect on the Company's business.

***Conflicts of Interest***

The Company's directors and officers may serve as directors or officers, or may be associated with other public companies or have significant shareholdings in other public companies. To the extent that such other companies may participate in business or asset acquisitions, dispositions, or ventures in which the Company may participate, the directors and officers of the Company may have a conflict of interest in negotiating and concluding terms respecting the transactions.

If a conflict of interest arises, the Company will rely on its code of ethics policy and applicable corporate legislation to which all directors and officers are subject. These provisions state that where a director has such a conflict, that director must, at a meeting of the company's directors, disclose his interest and refrain from voting. In accordance with the laws of the Province of British Columbia, the directors and officers of the Company are required to act honestly, in good faith and in the best interests of the Company.

### *Key Personnel*

The Company is depending on a relatively small number of key employees, the loss of any of whom could have an adverse effect on the Company. The Company does not have key person insurance on these individuals.

### *Share Price Volatility and Future Sales by Existing Shareholders*

In recent years, the securities markets have experienced a high level of price and volume volatility, and the market price of securities of many companies, particularly those considered to be development stage companies or early stage production companies without a proven history of sustainable cash flow, have experienced wide fluctuations which have not necessarily been related to the operating performance, underlying asset values or prospects of such companies. There can be no assurance that such fluctuations will not affect the price of the Company's securities. Also, subject to compliance with applicable securities laws, the Company's officers, directors, significant shareholders may sell some or all of their common shares in the future. No prediction can be made as to the effect, if any, such future sales of common shares will have on the market price of the Company's securities. The future sale of a substantial number of common shares by the Company's officers, directors, principal shareholders and their affiliates, or the perception that such sales could occur, could adversely affect prevailing market prices for the Company's securities.

## OFF-BALANCE SHEET ARRANGEMENTS

The Company has no off-balance sheet arrangements.

## FINANCIAL INFORMATION

The report for the quarter ended March 31, 2014 is expected to be published on or about May 8, 2014. In addition, the Company's annual general meeting of shareholders will be held on May 14, 2014 in Vancouver, British Columbia.

## BASIS OF PRESENTATION AND ACCOUNTING POLICIES

The Company prepared its financial statements in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). Note 3 of the audited consolidated financial statements for the year ended December 31, 2013 provides details of significant accounting policies and accounting policy decisions for significant or potentially significant areas that have had an impact on our financial statements or may have an impact in future periods.

As of January 1, 2013, the Company adopted the new and amended IFRS pronouncements in accordance with the transitional provisions outlined in the respective standards as listed below.

a) *Pronouncement affecting financial statement presentation or disclosures*

    i) IFRS 12, Disclosure of interests in other entities
    The Company adopted IFRS 12 on January 1, 2013. IFRS 12 establishes disclosure requirements for interests in other entities, such as subsidiaries, joint arrangements, associates, and unconsolidated structured entities. Refer to Note 13 of the audited consolidated financial statements for the year ended December 31, 2013 for disclosures with regards to the Company's subsidiaries.

ii) IFRS 13, Fair value measurement
The Company adopted IFRS 13 with prospective application from January 1, 2013. IFRS 13 is a comprehensive standard for fair value measurement and disclosure for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date.

The adoption of IFRS 13 did not have an effect on the Company's consolidated financial statements.

iii) Amendment to IAS 1, Presentation of Financial Statements
The Company adopted the amendments to IAS 1 on January 1, 2013, with restrospective application. The amendments to IAS 1 require items to be grouped within other comprehensive income that may be reclassified to profit or loss and those that will not be reclassified.

The adoption of the IAS 1 amendments did not have an effect on the Company's consolidated financial statements for the current period or prior period.

*b) Pronouncements affecting accounting policies only*

i) IFRS 10, Consolidated financial statements
The Company adopted IFRS 10 on January 1, 2013 with retrospective application. IFRS 10 requires an entity to consolidate an investee when it has power over the investee, is exposed, or has rights to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. IFRS 10 supercedes IAS 27, Consolidated and Separate Financial Statements and SIC 12, Consolidation – Special Purpose Entities.

The Company has concluded that IFRS 10 did not have an effect on the consolidated financial statements for the current year or prior years presented as the adoption did not result in the consolidation status of any of the subsidiaries.

ii) IFRS 11, Joint arrangements
The Company adopted IFRS 11 on January 1, 2013 with retrospective application. IFRS 11 requires a venturer to classify its interest in a joint agreement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation.

The Company has concluded that IFRS 11 did not have an effect on the consolidated financial statements for the current year or prior years presented as the Company does not have any joint arrangements.

iii) IFRIC 20, Stripping costs in the production phase of a surface mine
The Company adopted IFRIC 20 and applied the requirements to production stripping costs incurred on or after January 1, 2012, in accordance with the transitional provisions. The predecessor stripping assets recorded as of January 1, 2012, the date of the earliest period presented, have been reviewed in accordance with IFRIC 20. IFRIC 20 sets out the accounting for overburden waste removal (stripping) costs in the production phase of a mine.

The Company has identified components of ore bodies to be phases, pits or sub-pits depending on the ore body being analyzed. These components align with the view of the mine and the plan of mining activities. Previously, the Company recorded stripping activity relating to major expansions only. Under IFRIC 20, the Company recognizes stripping activity assets when the following three criteria are met:

- It is probable that the future economic benefit (improved access to the ore body) associated with the stripping activity will flow to the entity;
- The entity can identify the component of the ore body for which access has been improved; and
- The costs relating to the stripping activity associated with that component can be measured reliably.

Stripping activity assets capitalized under IFRIC 20 are classified within mineral properties, which is consistent with the classification of the asset these costs relate to.

These assets are amortized on a units-of-production basis over the remaining proven and probable reserves of the respective components.

The Company completed an analysis of IFRIC 20 and did not require any adjustments to the consolidated financial statements.

c) *Pronouncements issued but not yet effective*

In July 2013, the IASB tentatively decided to defer the mandatory effective date of IFRS 9. The IASB agreed that the mandatory effective date should no longer be annual periods beginning on or after January 1, 2015 but rather left open pending the finalization of the impairment and classification and measurement requirements.

## CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

The application of certain accounting policies requires the Company to make estimates that affect both the amount and timing of the recording of assets, liabilities, revenues and expenses. Some of these estimates require judgments about matters that are inherently uncertain.

Note 3 to the audited consolidated financial statements for the year ended December 31, 2013 includes a summary of the significant accounting policies adopted by the Company. The following policies are considered to be critical accounting policies since they involve the use of significant estimates.

### ***Depreciation, depletion and accretion***

Mineral properties and plant and equipment comprise a large component of the Company’s assets and as such, depreciation and depletion of these assets have a significant effect on the Company’s financial statements. Upon commencement of commercial production, the Company amortizes mineral property and mining equipment and other assets over the life of the mine based on the depletion of the mine’s proven and probable reserves. In the case of mining equipment and other assets, if the useful life of the asset is shorter than the life of the mine, the asset is amortized over its expected useful life.

Proven and probable reserves are determined based on a professional evaluation using accepted international standards for the assessment of mineral reserves. The assessment involves geological and geophysical studies and economic data and the reliance on a number of assumptions. The estimates of the reserves may change based on additional knowledge gained subsequent to the initial assessment. This may include additional data available from continuing exploration, results from the reconciliation of actual mining production data against the original reserve estimates, or the impact of economic factors such as changes in the price of commodities or the cost of components of production.

A change in the original estimate of reserves would result in a change in the rate of depreciation and amortization of the related mining assets and could result in an impairment of the mining assets.

***Mineral properties***

The Company carries the acquisition costs of its mineral properties at cost less any provision for impairment. The costs of each property will be amortized over the economic life of the property on a unit of production basis. Costs are charged to operations when a property is abandoned or when impairment in value, other than temporary, has been determined. Exploration costs are charged to operations as incurred.

The Company undertakes a periodic review of the carrying values of mineral properties and whenever events or changes in circumstances indicate that their carrying value may exceed their fair value. In undertaking this review, management of the Company is required to make significant estimates. These estimates are subject to various risks and uncertainties, which may ultimately have an effect on the expected recoverability of the carrying values of the mineral properties and related expenditures.

***Income taxes***

Deferred income tax assets and liabilities are determined based on differences between the financial statement carrying values of assets and liabilities and their respective income tax bases ("temporary difference"), and losses carried forward. Deferred income tax assets and liabilities are measured using tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by year end. The effect on deferred income tax assets and liabilities of a change in tax rates is included in operations in the period in which the change is substantively enacted. The amount of deferred income tax assets recognized is limited to the extent that it is probable that future tax profits will be available against which the temporary difference can be utilized.

Management of the Company is required to exercise judgments and make assumptions about the future performance of the Company in determining its ability to utilize loss carry-forwards and realize the benefits of deferred income tax assets.

***Stock-based compensation***

In calculating the fair value of stock options granted, management is required to make significant estimates in relation to the future volatility of the Company's share price and the period in which stock options will be exercised. Selection of a volatility factor and the estimate of the expected option life will have a significant impact on costs recognized for stock-based compensation. Estimates concerning volatility are made with reference to historical volatility, which is not necessarily an accurate indicator of volatility that will be experienced in the future. Management assumes that stock options will be exercised prior to their expiry date.

### ***Decommissioning and site restoration***

The Company has obligations for site restoration and decommissioning related to its diamond properties. The future obligations for decommissioning and site restoration activities are estimated by the Company using mine closure plans or other similar studies which outline the requirements that will be carried out to meet the obligations. Because the obligations are dependent on the laws and regulations of the countries in which the mines operate, the requirements could change as a result of amendments in the laws and regulations relating to environmental protection and other legislation affecting resource companies. As the estimate of obligations is based on future expectations, a number of assumptions and judgments are made by management in the determination of closure provisions. The decommissioning and site restoration provisions are more uncertain the further into the future the mine closure activities are to be carried out.

The Company's policy for recording decommissioning and site restoration provisions is to establish provisions for future mine closure costs at the commencement of mining operations based on the present value of the future cash flows required to satisfy the obligations. The amount of the present value of the provision is added to the cost of the related mining assets and depreciated over the life of the mine. The provision is accreted to its future value over the life of the mine through a charge to operating costs. Actual results could differ from estimates made by management during the preparation of these consolidated financial statements and those differences may be material.

## **INTERNAL FINANCIAL REPORTING AND DISCLOSURE CONTROLS**

Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted by it under securities legislation is recorded, processed, summarized and reported within the time periods specified in the securities legislation and include controls and procedures designed to ensure that information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted under securities legislation is accumulated and communicated to the Company's management, including its Chief Executive Officer and Principal Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Management, including the Chief Executive Officer and Principal Financial Officer, has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures. As of December 31, 2013, the Chief Executive Officer and Principal Financial Officer have each concluded that the Company's disclosure controls and procedures, as defined in NI 52-109 - Certification of Disclosure in Issuer's Annual and Interim Filings, are effective to achieve the purpose for which they have been designed.

Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with IFRS. Management is also responsible for the design of the Company's internal control over financial reporting in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS.

The Company's internal controls over financial reporting include policies and procedures that: pertain to the maintenance of records that, in reasonable detail accurately and fairly reflect the transactions and disposition of assets; provide reasonable assurance that transactions are recorded as necessary to permit preparation of the financial statements in accordance with IFRS and that receipts and expenditures are being made only in accordance with authorization of management and directors of the Company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the financial statements.

Because of their inherent limitations, internal controls over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Furthermore, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

## CAUTIONARY NOTE REGARDING FORWARD LOOKING STATEMENTS

Certain of the statements made and contained herein in the MD&A and elsewhere constitute forward-looking statements as defined in applicable securities laws. Generally, these forward-looking statements can be identified by the use of forward-looking terminology such as "expects", "anticipates", "believes", "intends", "estimates", "potential", "possible" and similar expressions, or statements that events, conditions or results "will", "may", "could" or "should" occur or be achieved.

In particular, this MD&A may contain forward looking information pertaining to the following: the estimates of the Company's mineral reserve and resources; estimates of the Company's production and sales volumes for the Karowe Mine; estimated costs to construct the Karowe Mine; start-up, exploration and development plans and objectives; production costs; exploration and development expenditures and reclamation costs; expectation of diamond price and changes to foreign currency exchange rates; expectations regarding the need to raise capital; possible impacts of disputes or litigation; and other risks and uncertainties described under the heading "Risks and Uncertainties" in the Company's Annual Information Form dated March 27, 2013 available at http://www.sedar.com (the "AIF").

Forward-looking statements are based on the opinions, assumptions and estimates of management as of the date such statements are made, and they are subject to a number of known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company to be materially different from any future results, performance or achievement expressed or implied by such forward-looking statements. Such assumptions include: the Company's ability to obtain necessary financing; the Company's expectations regarding the economy generally, results of operations and the extent of future growth and performance; and assumptions that the Company's activities will not be adversely disrupted or impeded by development, operating or regulatory risk. The Company believes that expectations reflected in this forward-looking information are reasonable but no assurance can be given that these expectations will prove to be correct and such forward-looking information included in this MD&A should not be unduly relied upon.

There can be no assurance that such statements will prove to be accurate, as the Company's results and future events could differ materially from those anticipated in this forward-looking information as a result of those factors discussed in or referred to under the heading "Risks and Uncertainties" in the Company's AIF, as well as changes in general business and economic conditions, changes in interest and foreign currency rates, the supply and demand for, deliveries of and the level and volatility of prices of rough diamonds, costs of power and diesel, acts of foreign governments and the outcome of legal proceedings, inaccurate geological and recoverability assumptions (including with respect to the size, grade and recoverability of mineral reserves and resources), unanticipated operational difficulties (including failure of plant, equipment or processes to operate in accordance with specifications or expectations, cost escalations, unavailability of materials and equipment, government action or delays in the receipt of government approvals, industrial disturbances or other job actions, adverse weather conditions, and unanticipated events relating to health safety and environmental matters)

Accordingly, readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date the statements were made, and the Company does not assume any obligations to update or revise them to reflect new events or circumstances, except as required by law.

February 20, 2014

## Independent Auditor's Report

**To the Shareholders of Lucara Diamond Corp.**

We have audited the accompanying consolidated financial statements of Lucara Diamond Corp., which comprise the consolidated balance sheets as at December 31, 2013 and December 31, 2012 and the consolidated statements of operations, comprehensive income (loss), cash flows and changes in equity for the years then ended, and the related notes, which comprise 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 International Financial Reporting Standards, 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 purpose 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 Lucara Diamond Corp. as at December 31, 2013 and December 31, 2012 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

*signed "PricewaterhouseCoopers LLP"*

**Chartered Accountants**

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# LUCARA DIAMOND CORP.
## CONSOLIDATED BALANCE SHEETS
**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

| | December 31, 2013 | December 31, 2012 |
|---|---|---|
| **ASSETS** | | |
| Current assets | | |
| Cash (Note 21) | $ 49,364 | $ 13,261 |
| Investments (Note 21) | 90 | 86 |
| Trade receivables and other (Note 5) | 3,593 | 5,527 |
| Inventories (Note 6) | 21,132 | 13,300 |
| | 74,179 | 32,174 |
| Plant and equipment (Note 7) | 100,886 | 118,395 |
| Mineral properties (Note 8) | 72,061 | 84,645 |
| Other non-current assets | 62 | 137 |
| **TOTAL ASSETS** | $ 247,188 | $ 235,351 |
| **LIABILITIES** | | |
| Current liabilities | | |
| Trade payables and accrued liabilities (Note 21) | $ 15,491 | $ 14,695 |
| Current portion of long-term debt (Note 9) | - | 30,311 |
| | 15,491 | 45,006 |
| Long-term debt (Note 9) | - | 20,643 |
| Restoration provisions (Note 10) | 14,515 | 12,242 |
| Future income taxes (Note 17) | 14,258 | - |
| **TOTAL LIABILITIES** | 44,264 | 77,891 |
| **EQUITY** | | |
| Share capital (Note 11) | 283,609 | 282,796 |
| Contributed surplus (Note 12) | 5,108 | 4,874 |
| Cumulative deficit | (45,516) | (110,740) |
| Accumulated other comprehensive loss | (41,820) | (21,381) |
| Total equity attributable to shareholders of the Company | 201,381 | 155,549 |
| Non-controlling interests (Note 13) | 1,543 | 1,911 |
| **TOTAL EQUITY** | 202,924 | 157,460 |
| **TOTAL LIABILITIES AND EQUITY** | $ 247,188 | $ 235,351 |

Commitments (Note 23) and subsequent events (Note 24)

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

Approved on Behalf of the Board of Directors:

"Paul K. Conibear"
Director

"William Lamb"
Director

# LUCARA DIAMOND CORP.
## CONSOLIDATED STATEMENTS OF OPERATIONS
## FOR THE YEARS ENDED DECEMBER 31
## (All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)

| | | 2013 | | 2012 |
|---|---|---|---|---|
| **Revenues** | $ | 180,507 | $ | 41,830 |
| **Cost of goods sold** | | | | |
| Operating expenses | | 43,835 | | 13,992 |
| Royalty expenses (Note 8) | | 18,051 | | 4,183 |
| Depletion, amortization and accretion | | 14,979 | | 5,898 |
| | | 76,865 | | 24,073 |
| **Income from mining operations** | | 103,642 | | 17,757 |
| **Other expenses** | | | | |
| Exploration and other mine costs (Note 14) | | 1,323 | | 12,854 |
| Administration (Note 15) | | 11,429 | | 9,534 |
| Gain on sale of exploration program diamonds (Note 16) | | (584) | | - |
| Sales and marketing | | 3,523 | | 1,481 |
| Finance expenses | | 3,785 | | 3,103 |
| Foreign exchange loss (gain) | | 3,953 | | (1,690) |
| | | 23,429 | | 25,282 |
| **Net income (loss) before tax** | | 80,213 | | (7,525) |
| **Income tax expense** (Note 17) | | | | |
| Current income tax | | 96 | | - |
| Future income tax | | 14,895 | | - |
| | | 14,991 | | - |
| **Net income (loss) for the year** | $ | 65,222 | $ | (7,525) |
| **Attributable to:** | | | | |
| Shareholders of the Company | $ | 65,317 | $ | (5,911) |
| Non-controlling interests | $ | (95) | $ | (1,614) |
| **Income (loss) per common share (Note 18)** | | | | |
| Basic | $ | 0.17 | $ | (0.02) |
| Diluted | $ | 0.17 | $ | (0.02) |
| **Weighted average common shares outstanding (Note 18)** | | | | |
| Basic | | 376,392,625 | | 374,621,554 |
| Diluted | | 376,512,990 | | 374,621,554 |

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

# LUCARA DIAMOND CORP.
## CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
## FOR THE YEARS ENDED DECEMBER 31
## (All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)

| | | 2013 | | 2012 |
|---|---|---|---|---|
| **Net income (loss) for the year** | $ | 65,222 | $ | (7,525) |
| **Other comprehensive loss** | | | | |
| Change in fair value of available-for-sale securities | | 11 | | (26) |
| Currency translation adjustment | | (20,816) | | (8,246) |
| | | (20,805) | | (8,272) |
| **Comprehensive income (loss)** | $ | 44,417 | $ | (15,797) |
| **Comprehensive income (loss) attributable to:** | | | | |
| Shareholders of the Company | | 44,878 | | (14,092) |
| Non-controlling interests | | (461) | | (1,705) |
| | $ | 44,417 | $ | (15,797) |

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

## LUCARA DIAMOND CORP.
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**FOR THE YEARS ENDED DECEMBER 31**
**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

| | 2013 | 2012 |
|---|---|---|
| **Cash flows from (used in):** | | |
| **Operating Activities** | | |
| Net income (loss) for the year | $ 65,222 | $ (7,525) |
| Items not involving cash: | | |
| Depletion, amortization, accretion and depreciation | 15,402 | 9,306 |
| Foreign exchange gain | - | (1,037) |
| Stock-based compensation | 517 | 286 |
| Deferred income taxes | 14,895 | - |
| Finance costs | 3,527 | 2,779 |
| | 99,563 | 3,809 |
| Net changes in working capital items: | | |
| VAT receivables and other current assets | 2,060 | 706 |
| Inventories | (6,953) | (10,123) |
| Trade payables and other current liabilities | 3,893 | 8,505 |
| | 98,563 | 2,897 |
| **Financing Activities** | | |
| Repayments of debenture | (50,000) | - |
| Drawdown of revolving credit facility | - | 9,500 |
| Repayments of revolving credit facility | (4,500) | (5,000) |
| Finance costs paid | - | (585) |
| Proceeds from exercise of stock options | 530 | 2,620 |
| | (53,970) | 6,535 |
| **Investing Activities** | | |
| Acquisition of plant and equipment | (7,865) | (44,441) |
| Other | 54 | 7 |
| | (7,811) | (44,434) |
| **Effect of exchange rate change on cash** | (679) | (326) |
| **Increase (decrease) in cash during the year** | 36,103 | (35,328) |
| **Cash, beginning of year** | 13,261 | 48,589 |
| **Cash, end of year** | $ 49,364 | $ 13,261 |
| **Supplemental Information** | | |
| Interest received (paid) | (109) | 311 |
| Taxes paid | 96 | - |
| Changes in accounts payable and accrued liabilities related to plant and equipment | (2,870) | (10,621) |

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

# LUCARA DIAMOND CORP.

**CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**
**FOR THE YEARS ENDED DECEMBER 31**
**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

| | Number of shares issued and outstanding | Share capital | Contributed surplus | Cumulative deficit | Accumulated other comprehensive loss | Non-controlling interests | Total |
|---|---|---|---|---|---|---|---|
| **Balance, January 1, 2012** | 372,349,049 | $ 278,995 | $ 5,769 | $ (104,244) | $ (13,200) | $ 3,031 | $ 170,351 |
| Exercise of stock options | 3,943,700 | 3,801 | (1,181) | - | - | - | 2,620 |
| Stock-based compensation | - | - | 286 | - | - | - | 286 |
| Effect of foreign currency translation | - | - | - | - | (8,155) | (91) | (8,246) |
| Unrealized loss on investments | - | - | - | - | (26) | - | (26) |
| Free-carried non-controlling interests (Note 13) | - | - | - | (585) | - | 585 | - |
| Net loss for the year | - | - | - | (5,911) | - | (1,614) | (7,525) |
| **Balance, December 31, 2012** | 376,292,749 | $ 282,796 | $ 4,874 | $ (110,740) | $ (21,381) | $ 1,911 | $ 157,460 |
| **Balance, January 1, 2013** | 376,292,749 | $ 282,796 | $ 4,874 | $ (110,740) | $ (21,381) | $ 1,911 | $ 157,460 |
| Exercise of stock options | 606,666 | 813 | (283) | - | - | - | 530 |
| Stock-based compensation | - | - | 517 | - | - | - | 517 |
| Effect of foreign currency translation | - | - | - | - | (20,450) | (366) | (20,816) |
| Unrealized gain on investments | - | - | - | - | 11 | - | 11 |
| Free-carried non-controlling interests (Note 13) | - | - | - | (93) | - | 93 | - |
| Net income for the year | - | - | - | 65,317 | - | (95) | 65,222 |
| **Balance, December 31, 2013** | 376,899,415 | $ 283,609 | $ 5,108 | $ (45,516) | $ (41,820) | $ 1,543 | $ 202,924 |

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

## 1. NATURE OF OPERATIONS

Lucara Diamond Corp. together with its subsidiaries (collectively referred to as the "Company") is a diamond mining company focused on the development and operation of diamond properties in Africa. The Company holds a 100% interest in the Karowe Mine (previously named AK6 Diamond Project) located in Botswana and a 75% interest in Mothae Diamond Project located in Lesotho.

The Company's common shares are listed on the TSX, NASDAQ OMX First North and Botswana Stock Exchanges. The Company was continued into the Province of British Columbia under the Business Corporations Act (British Columbia) in August 2004 and its registered office is located at Suite 2610 - 1066 West Hastings Street, Vancouver, British Columbia, V6C 3E8.

## 2. BASIS OF PRESENTATION

The Company prepared its financial statements in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). The same accounting policies have been consistently applied in all periods presented.

These financial statements were approved by the Board of Directors for issue on February 20, 2014.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies used in the preparation of these consolidated financial statements are as follows:

*(a) Basis of measurement*

These consolidated financial statements have been prepared under the historical cost convention, except for investments in equity securities, which are measured at fair value.

*(b) Consolidation*

These consolidated financial statements include the accounts of the Company and all of its subsidiaries.

Subsidiaries are entities controlled by the Company. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Subsidiaries are included in the consolidated financial statements from the date control is obtained until the date control ceases. Where the Company's interest is less than 100%, the Company recognized non-controlling interests. All intercompany balances, transactions, income, expenses, profits and losses, including unrealized gains and losses have been eliminated on consolidation. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Company.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Non-controlling interests represent the equity in a subsidiary not attributable, directly and indirectly, to the Company and is presented separately within equity in the consolidated balance sheet, separately from equity attributable to the shareholders of the Company. Losses within a subsidiary continue to be attributed to the non-controlling interests even if that results in a deficit balance. Changes in the Company's ownership interest in subsidiaries that do not result in a loss of control are accounted for as equity transactions.

*(c) Critical accounting estimates and judgments*

The preparation of consolidated financial statements requires management to use judgment in applying its accounting policies and estimates and assumptions about the future. Estimates and other judgments are continuously evaluated and are based on management's experience and other factors, including expectations about future events that are believed to be reasonable under the circumstances. The following discusses the most significant accounting judgments and estimates that the Company has made in the preparation of the consolidated financial statements:

*Valuation of mineral properties* – The Company carries the acquisition costs of its mineral properties at cost less any provision for impairment. The Company undertakes a periodic review of the carrying values of mineral properties and whenever events or changes in circumstances indicate that their carrying values may exceed their fair value. In undertaking this review, management of the Company is required to make significant judgments. These judgments are subject to various risks and uncertainties, which may ultimately have an effect on the expected recoverability of the carrying values of the mineral properties and related expenditures.

*Utilization of tax losses* – The Company is subject to income taxes in a number of jurisdictions. At present all of the entities, except Boteti Mining (PTY) Ltd. are making tax losses. These tax losses are only recognized to the extent that expected future taxable profits are available.

*Stock based compensation* – The fair value of stock options is determined using the Black-Scholes option pricing model and are expensed over their vesting periods. In estimating fair value, management of the Company is required to make certain assumptions and estimates regarding the life of the options, volatility and forfeitures rates. Changes in the assumptions used could result in materially different results.

*Decommissioning and site restoration* – The Company has obligations for site restoration and decommissioning related to its diamond properties. The future obligations for decommissioning and site restoration activities are estimated by the Company using mine closure plans or other similar studies which outline the requirements that will be carried out to meet the obligations. Because the obligations are dependent on the laws and regulations of the countries in which the mines operate, the requirements could change as a result of amendments in the laws and regulations relating to environmental protection and other legislation affecting resource companies. As the estimate of obligations is based on future expectations, a number of assumptions and judgments are made by management in the determination of closure provisions. The decommissioning and site restoration provisions are more uncertain the further into the future the mine closure activities are to be carried out.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The Company's policy for recording decommissioning and site restoration provisions is to establish provisions for future mine closure costs at the commencement of mining operations based on the present value of the future cash flows required to satisfy the obligations. The amount of the present value of the provision is added to the cost of the related mining assets and depreciated over the life of the mine. The provision is accreted to its future value over the life of the mine through a charge to operating costs. Actual results could differ from estimates made by management during the preparation of these consolidated financial statements and those differences may be material.

*(d) Segment reporting*

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker, who is responsible for allocating resources and assessing performance of the operating segments, has been identified as the person that makes strategic decisions. The CEO is deemed the chief operating decision-maker of the Company.

The Company's primary reporting segments are based on individual diamond properties, being the Karowe Mine and the Mothae Diamond Project and Corporate. The Corporate office provides support to the diamond properties with respect to treasury and finance, technical support, regulatory reporting and corporate administration.

*(e) Foreign currency translation*

*Functional and presentation currency*

Items included in the financial statements of each of the Company's entities are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The consolidated financial statements are presented in U.S. dollars. The functional currency of the parent company, Lucara Diamond Corp., is the Canadian dollar.

*Transactions and balances*

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at exchange rates of monetary assets and liabilities denominated in currencies other than an entity's functional currency are recognized in the statement of operations.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

*Group companies*

The functional currency of the significant subsidiaries of the Company are Boteti Mining (PTY) Ltd., which has a Pula functional currency and Mothae Diamonds (Pty) Ltd, which has a Loti functional currency. The results and financial position of the group companies, which have a functional currency different from the presentation currency, are translated into the presentation currency as follows:

(i) Assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet
(ii) Income and expenses for each statement of operation are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the rate on the dates of the transactions).
(iii) All resulting exchange differences are recognized in other comprehensive income as cumulative translation adjustments.

*(f) Cash*

Cash include cash on hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less.

*(g) Financial instruments*

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership. Financial liabilities are derecognized when the obligation specified in the contract is discharged, cancelled or expires.

At initial recognition, the Company classifies its financial instruments in the following categories:

(i) Financial assets and liabilities at fair value through profit or loss: A financial asset or liability is classified in this category if acquired principally for the purpose of selling or repurchasing in the short-term. Derivatives are also included in this category unless they are designated as hedges.

Financial instruments in this category are recognized initially and subsequently at fair value. Transaction costs are expensed in the consolidated statement of operations. Gains and losses arising from changes in fair value are presented in the consolidated statement of operations within "other gains and losses" in the period in which they arise. Non-derivative financial assets and liabilities at fair value through profit or loss are classified as current except for the portion expected to be realized or paid beyond twelve months of the balance sheet date, which are classified as non-current.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

(ii) Available-for-sale investments: Available-for-sale investments are non-derivatives that are either designated in this category or not classified in any of the other categories.

Available-for-sale investments are recognized initially at fair value plus transaction costs and are subsequently carried at fair value. Gains or losses arising from remeasurement are recognized in other comprehensive income. When an available-for-sale investment is sold or impaired, the accumulated gains or losses are moved from accumulated other comprehensive income to the statement of operations and are included in "other gains and losses". Available-for-sale investments are classified as non-current, unless an investment matures within twelve months, or management expects to dispose of it within twelve months.

(iii) Loans and receivables: Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The Company's loans and receivables comprise cash and trade receivables and are included in current assets due to their short-term nature. Loans and receivables are initially recognized at the amount expected to be received, less, when material, a discount to reduce the loans and receivables to fair value. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment.

(iv) Financial liabilities at amortized cost: Financial liabilities at amortized cost include trade payables, bank debt and long-term debt. Trade payables are initially recognized at the amount required to be paid, less, when material, a discount to reduce the payables to fair value. Subsequently, trade payables are measured at amortized cost using the effective interest method. Bank debt and long-term debt are recognized initially at fair value, net of any transaction costs incurred and subsequently at amortized cost using the effective interest method. These are classified as current liabilities if payment is due within twelve months. Otherwise, they are presented as non-current liabilities.

*Impairment of financial assets*

At each reporting date, the Company assesses whether there is objective evidence that a financial asset (other than a financial asset classified as fair value through profit or loss) is impaired.

The criteria used to determine if objective evidence of an impairment loss exists include:

(i) significant financial difficulty of the obligor;
(ii) delinquencies in interest or principal payments; and
(iii) it becomes probable that the borrower will enter bankruptcy or other financial reorganization.

For equity securities, a significant or prolonged decline in the fair value of the security below its cost is also evidence that the assets are impaired.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

If such evidence exists, the Company recognizes an impairment loss, as follows:

(i) Financial assets carried at amortized cost: The loss is the difference between the amortized cost of the loan or receivable and the present value of the estimated future cash flows, discounted using the instrument's original effective interest rate. The carrying amount of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

(ii) Available-for-sale financial assets: The impairment loss is the difference between the original cost of the asset and its fair value at the measurement date, less any impairment losses previously recognized in the statement of operations. This amount represents the loss in accumulated other comprehensive income that is reclassified to net loss.

Impairment losses on financial assets carried at amortized cost and available-for-sale debt instruments are reversed in subsequent periods if the amount of the loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized. Impairment losses on available-for-sale equity instruments are not reversed.

*(h) Inventories*

Inventories, which include rough diamonds, ore stock piles and consumables, are measured at the lower of cost and net realizable value. The amount of any write-down of inventories to net realizable value and all losses, are recognized in the period the write-down of loss occurs. Cost is determined using the weighted average method. Cost includes directly attributable mining overhead but excludes borrowing costs.

Net realizable value represents the estimated selling price in the ordinary course of business, less all estimated costs to completion and selling expenses.

*(i) Plant and equipment*

Plant and equipment are stated at cost less accumulated depreciation and impairment losses. The cost of an asset consists of its purchase price, any directly attributable costs of bringing the asset to its present working condition and location for its intended use and an initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably.

Depreciation of each asset is calculated using the straight line or unit of production method to allocate its cost less its residual value over its estimated useful life. The estimated useful lives of plant and equipment are as follows:

| | |
|---|---|
| Machinery | 5 to 10 years |
| Plant facilities | based on resources on a unit of production basis |
| Furniture and office equipment | 2 to 3 years |

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount.

Gains and losses on disposals are determined by comparing the proceeds with the carrying amount and are recognized within "other gains and losses" in the statement of operations.

*(j) Exploration and evaluation expenditures and mineral properties*

Exploration and evaluation expenditures relate to the search for mineral resources, the determination of technical feasibility and the assessment of commercial viability of an identified resource. Exploration and evaluation activities include:

- Researching and analyzing historical exploration data;
- Gathering exploration data through topographical, geochemical and geophysical studies;
- Exploratory drilling, trenching and sampling;
- Determining and examining the volume and grade of the resource; and
- Surveying, transportation and infrastructure requirement

Exploration and development expenditures are expensed as incurred on mineral properties not sufficiently advanced as to identify their development potential. When it has been established that a mineral property is considered to be sufficiently advanced and an economic analysis has been completed, all further expenditures for the current year and subsequent years are capitalized as incurred. Costs associated with acquiring a mineral property are capitalized as incurred.

*(k) Intangible assets*

Intangible assets are initially recognized at cost and measured subsequently at cost less accumulated amortization and impairment losses. Finite-lived intangible assets are amortized based on resources over a unit of production basis.

*(l) Impairment of non-financial assets*

Long lived assets are reviewed for impairment when events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Non-financial assets that suffered impairment are reviewed for possible reversal of the impairment at each reporting date.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

(m) *Provisions*

*Asset retirement obligations*

The Company recognizes a liability for an asset retirement obligation on long-lived assets when a present legal or constructive obligation exists, as a result of past events and the amount of the liability is reasonably determinable. Asset retirement obligations are initially recognized and recorded as a liability based on estimated future cash flows discounted at a risk free rate. This is adjusted at each reporting period for changes to factors including the expected amount of cash flows required to discharge the liability, the timing of such cash flows and the risk free discount rate. Corresponding amounts and adjustments are added to the carrying value of the related long-lived asset and amortized or depleted to operations over the life of the related asset.

*Environmental expenditures*

Environmental expenditures that relate to current operations are expensed or capitalized as appropriate. Expenditures that relate to an existing condition caused by past operations and which do not contribute to current or future revenue generation are expensed. Liabilities are recorded when environmental assessments and/or remedial efforts are probable, and the costs can be reasonably estimated.

*Other provisions*

Provisions are recognized when:

- the Company has a present legal or constructive obligation as a result of a past event;
- a reliable estimate can be made of the obligation.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation, using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the obligation. The increase in the provision due to the passage of time is recognized as finance costs.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

*(n) Deferred income taxes*

Deferred tax is recognized using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized for the following temporary differences: the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable income, and differences relating to investments in subsidiaries and jointly controlled entities to the extent that it is probable that they will not reverse in the foreseeable future. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill.

Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the year end.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities where there is a legal right to do so, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized to the extent that it is probable that future tax profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each year end and are reduced to extent that is no longer probable that the related tax benefit will be realized.

*(o) Share capital*

Common shares are classified as equity.

Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds.

*(p) Revenue recognition*

Revenues from diamond sales are recognized when the risks and rewards of ownership pass to the customer which is when proceeds are received and title is transferred to the purchaser.

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

*(q) Royalties*

Royalties and revenue-based taxes are accounted for under IAS 12 when they have the characteristics of income tax. This is considered to be the case when they are imposed under Government authority and the amount payable is based on taxable income – rather than based on quantity produced or as a percentage of revenue. For such arrangements, current and deferred tax is provided on the same basis as described above for other forms of taxation. Obligations arising from royalty arrangements that do not satisfy these criteria are recognized as current provisions and disclosed as part of royalty expenses. The royalties incurred by the Company are considered not to meet the criteria to be treated as part of income tax.

*(r) Stock-based compensation*

The Company has a stock-based compensation plan, under which the entity receives services from employees and non-employees as consideration for equity instruments (options) of the Company.

Stock options granted to employees are measured on the grant date. Stock options granted to non-employees are measured on the date that the goods or services are received.

The fair value of the employee and non-employee services received in exchange for the grant of the options is recognized as an expense. The total amount to be expensed is determined by reference to the fair value of the options granted and the vesting periods. The total expense is recognized over the vesting period, which is the period over which all of the specified vesting conditions are to be satisfied.

The cash subscribed for the shares issued when the options are exercised is credited to share capital, net of any directly attributable transaction costs.

*(s) Income (loss) per share*

Income (loss) per share is calculated by dividing the income (loss) attributable to the shareholders of the Company by the weighted average number of common shares issued and outstanding during the year. Diluted income (loss) per share is calculated using the treasury stock method.

*(t) Leases*

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the statement of operations on a straight-line basis over the period of the lease.

*(u) Borrowing costs*

Borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset are capitalized as part of the cost of that asset. Other borrowing costs not directly attributable to a qualifying asset are expensed in the period incurred.

## 4. ADOPTION OF NEW IFRS PRONOUNCEMENTS

As of January 1, 2013, the Company adopted the new and amended IFRS pronouncements in accordance with the transitional provisions outlined in the respective standards as listed below.

*a) Pronouncement affecting financial statement presentation or disclosures*

i) IFRS 12, Disclosure of interests in other entities
The Company adopted IFRS 12 on January 1, 2013. IFRS 12 establishes disclosure requirements for interests in other entities, such as subsidiaries, joint arrangements, associates, and unconsolidated structured entities. Refer to Note 13 for disclosures with regards to the Company's subsidiaries.

ii) IFRS 13, Fair value measurement
The Company adopted IFRS 13 with prospective application from January 1, 2013. IFRS 13 is a comprehensive standard for fair value measurement and disclosure for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date.

The adoption of IFRS 13 did not have an effect on the Company's consolidated financial statements.

iii) Amendment to IAS 1, Presentation of Financial Statements
The Company adopted the amendments to IAS 1 on January 1, 2013, with restrospective application. The amendments to IAS 1 require items to be grouped within other comprehensive income that may be reclassified to profit or loss and those that will not be reclassified.

The adoption of the IAS 1 amendments did not have an effect on the Company's condensed interim consolidated financial statements for the current period or prior period.

*b) Pronouncements affecting accounting policies only*

i) IFRS 10, Consolidated financial statements
The Company adopted IFRS 10 on January 1, 2013 with retrospective application. IFRS 10 requires an entity to consolidate an investee when it has power over the investee, is exposed, or has rights to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. IFRS 10 supercedes IAS 27, Consolidated and Separate Financial Statements and SIC 12, Consolidation – Special Purpose Entities.

The Company has concluded that IFRS 10 did not have an effect on the consolidated financial statements for the current year or prior years presented as the adoption did not result in the consolidation status of any of the subsidiaries.

## 4. ADOPTION OF NEW IFRS PRONOUNCEMENTS (continued)

ii) IFRS 11, Joint arrangements
The Company adopted IFRS 11 on January 1, 2013 with retrospective application. IFRS 11 requires a venturer to classify its interest in a joint agreement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation.

The Company has concluded that IFRS 11 did not have an effect on the consolidated financial statements for the current year or prior years presented as the Company does not have any joint arrangements.

iii) IFRIC 20, Stripping costs in the production phase of a surface mine
The Company adopted IFRIC 20 and applied the requirements to production stripping costs incurred on or after January 1, 2012, in accordance with the transitional provisions. The predecessor stripping assets recorded as of January 1, 2012, the date of the earliest period presented, have been reviewed in accordance with IFRIC 20. IFRIC 20 sets out the accounting for overburden waste removal (stripping) costs in the production phase of a mine.

The Company has identified components of ore bodies to be phases, pits or sub-pits depending on the ore body being analyzed. These components align with the view of the mine and the plan of mining activities. Previously, the Company recorded stripping activity relating to major expansions only. Under IFRIC 20, the Company recognizes stripping activity assets when the following three criteria are met:

- It is probable that the future economic benefit (improved access to the ore body) associated with the stripping activity will flow to the entity;
- The entity can identify the component of the ore body for which access has been improved; and
- The costs relating to the stripping activity associated with that component can be measured reliably.

Stripping activity assets capitalized under IFRIC 20 are classified within mineral properties, which is consistent with the classification of the asset these costs relate to.

These assets are amortized on a units-of-production basis over the remaining proven and probable reserves of the respective components.

The Company completed an analysis of IFRIC 20 and did not require any adjustments to the consolidated financial statements.

*c) Pronouncements issued but not yet effective*

In July 2013, the IASB tentatively decided to defer the mandatory effective date of IFRS 9. The IASB agreed that the mandatory effective date should no longer be annual periods beginning on or after January 1, 2015 but rather left open pending the finalization of the impairment and classification and measurement requirements.

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 5. TRADE RECEIVABLES AND OTHER

| | 2013 | 2012 |
|---|---|---|
| VAT | $ 2,694 | $ 3,034 |
| Trade | - | 1,503 |
| Other | 233 | 248 |
| Prepayments | 666 | 742 |
| | $ 3,593 | $ 5,527 |

## 6. INVENTORIES

| | 2013 | 2012 |
|---|---|---|
| Rough diamonds | $ 9,026 | $ 8,444 |
| Ore stockpile | 6,674 | 1,797 |
| Parts and supplies | 5,432 | 3,059 |
| | $ 21,132 | $ 13,300 |

Inventory expensed during the year ended December 31, 2013 totaled $43.8 million (2012 – $14.0 million).

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 7. PLANT AND EQUIPMENT

| Cost | Construction in progress | Mine and plant facilities | Vehicles | Furniture and office equipment | Total |
|---|---|---|---|---|---|
| **Balance, January 1, 2012** | $ 86,720 | $ 7,766 | $ 1,314 | $ 2,319 | $ 98,119 |
| Additions | 27,070 | 8,027 | 284 | 1,241 | 36,622 |
| Disposals and other | 862 | - | (2) | (1,129) | (269) |
| Translation differences | (1,256) | (2,759) | (54) | (70) | (4,139) |
| Reclassification | (113,396) | 113,396 | - | - | - |
| **Balance, December 31, 2012** | - | 126,430 | 1,542 | 2,361 | 130,333 |
| Additions | - | 5,212 | 100 | 293 | 5,605 |
| Disposals and other | - | (964) | (36) | 334 | (666) |
| Translation differences | - | (14,748) | (187) | (281) | (15,216) |
| **Balance, December 31, 2013** | $ - | $ 115,930 | $ 1,419 | $ 2,707 | $ 120,056 |
| | | | | | |
| **Accumulated depreciation** | | | | | |
| **Balance, January 1, 2012** | $ - | $ 3,164 | $ 282 | $ 171 | $ 3,617 |
| Depletion, amortization and accretion for the year | - | 7,922 | 334 | 431 | 8,687 |
| Disposals and other | - | - | - | - | - |
| Translation differences | - | (334) | (18) | (14) | (366) |
| **Balance, December 31, 2012** | - | 10,752 | 598 | 588 | 11,938 |
| Depletion, amortization and accretion for the year | - | 8,515 | 382 | 619 | 9,516 |
| Disposals and other | - | (33) | (35) | 12 | (56) |
| Translation differences | - | (2,042) | (90) | (96) | (2,228) |
| **Balance, December 31, 2013** | $ - | $ 17,192 | $ 855 | $ 1,123 | $ 19,170 |
| **Net book value** | | | | | |
| **As at December 31, 2012** | $ - | $ 115,678 | $ 944 | $ 1,773 | $ 118,395 |
| **As at December 31, 2013** | $ - | $ 98,738 | $ 564 | $ 1,584 | $ 100,886 |

During the year ended December 31, 2012, the Company reduced plant and equipment by $12.8 million relating to diamonds sold during the pre-commercial production period.

Plant and equipment include interest and financing costs relating to the construction of plant and equipment prior to the commencement of commercial production. Interest and financing costs are capitalized only for the project for which funds have been borrowed. Interest expense capitalized in 2013 was nil (2012 – $2.5 million).

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 8. MINERAL PROPERTIES

| **Cost** | **Karowe Mine** | **Mothae Diamond** | **Mothae mining license** | **Total** |
|---|---|---|---|---|
| **Balance, January 1, 2012** | $ 68,502 | $ 18,226 | $ 3,315 | $ 90,043 |
| Additions | - | 29 | - | 29 |
| Disposals and other | (547) | - | - | (547) |
| Translation differences | (2,451) | (567) | (138) | (3,156) |
| **Balance, December 31, 2012** | 65,504 | 17,688 | 3,177 | 86,369 |
| Additions | 2,324 | - | - | 2,324 |
| Disposals and other | (500) | (74) | - | (574) |
| Translation differences | (7,459) | (1,773) | (609) | (9,841) |
| **Balance, December 31, 2013** | $ 59,869 | $ 15,841 | $ 2,568 | $ 78,278 |
| **Accumulated depletion** | | | | |
| **Balance, January 1, 2012** | $ - | $ - | $ - | $ - |
| Depletion for the year | 1,761 | - | - | 1,761 |
| Disposals and other | - | - | - | - |
| Translation differences | (37) | - | - | (37) |
| **Balance, December 31, 2012** | 1,724 | - | - | 1,724 |
| Depletion for the year | 4,896 | - | - | 4,896 |
| Disposals and other | - | - | - | - |
| Translation differences | (403) | - | - | (403) |
| **Balance, December 31, 2013** | $ 6,217 | $ - | $ - | $ 6,217 |
| **Net book value** | | | | |
| **As at December 31, 2012** | $ 63,780 | $ 17,688 | $ 3,177 | $ 84,645 |
| **As at December 31, 2013** | $ 53,652 | $ 15,841 | $ 2,568 | $ 72,061 |

a) *Karowe Mine*

A royalty of 10% of the sales value of diamonds produced from Karowe is payable to the government of Botswana.

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 8. MINERAL PROPERTIES (continued)

*b) Mothae Diamond Project*

Pursuant to the terms of the mining agreement, Mothae Diamonds, an indirect 75% owned subsidiary of the Company has a 100% interest in the project. The remaining 25% of Mothae Diamonds is held by the Government of Lesotho (Note 13). One half of the project interest held by the Government is a free carried interest and one half is funded by the Government through its share of project dividends. During an initial pre-production test mining stage, a royalty of 4% of the sales value of diamonds produced from Mothae has been paid to the government. At full production the royalty will increase to 8% of diamond sales value. The mining lease is valid until September 2019 and renewable for an additional 10 years.

## 9. LONG-TERM DEBT

| | 2013 | 2012 |
|---|---|---|
| Debenture (a) | | |
| Principal | $ - | $ 50,000 |
| Unamortized discount | - | (3,179) |
| Revolving credit facility (b) | - | 4,500 |
| Deferred finance charges (b) | - | (367) |
| | - | 50,954 |
| Less: Current portion | - | (30,311) |
| Long-term portion of long-term debt | $ - | $ 20,643 |

*a) Debenture*

Through agreements in July 2011 and in July 2012, the Company secured a $50 million debenture to fund the development of the Company's projects. The debenture was repayable in quarterly repayments of $8.3 million commencing March 31, 2013 and a final maturity date of June 30, 2014. No interest was payable during the term of the facility.

The terms of the debenture financing also included the Company issuing an aggregate of 9 million common shares (fair value $10.7 million) to Zebra and Lorito as consideration for the facility, in lieu of interest and fees. During the year ended December 31, 2013, accretion of $3.2 million (2012 - $5.0 million) was recorded of which nil (2012 - $2.5 million) was been capitalized in plant and equipment (Note 7).

During the year ended December 31, 2013, the Company repaid this debenture in full and recorded a foreign exchange loss on settlement of $2.1 million.

(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)

## 9. LONG-TERM DEBT (continued)

The borrowings were measured initially at fair value. The liability was subsequently measured at amortized cost using the effective interest method, with interest expense recognized on an effective yield basis. The effective interest rate was the rate that exactly discounts estimated future cash payments through the expected life of the financial liability, or (where appropriate) a shorter period, to the net carrying amount on initial recognition.

| **As at December 31, 2013** | **Current portion** | **Long-term portion** | **Total** |
|---|---|---|---|
| Principal | $ - | $ - | $ - |
| Unamortized discount | - | - | - |
| Total carrying value | $ - | $ - | $ - |

| **As at December 31, 2012** | **Current portion** | **Long-term portion** | **Total** |
|---|---|---|---|
| Principal | $ 33,333 | $ 16,667 | $ 50,000 |
| Unamortized discount | (2,729) | (450) | (3,179) |
| Total carrying value | $ 30,604 | $ 16,217 | $ 46,821 |

*b) Revolving credit facility*

In April 2012, the Company signed a definitive agreement with the Bank of Nova Scotia for a $25 million revolving term credit facility with a maturity date of March 26, 2014, which may be extended if both parties agree. Funds drawn under the revolving credit facility are due in full at maturity. The facility contains financial and non-financial covenants customary for a facility of this size and nature. As at December 31, 2013, the Company is in compliance with all financial and non-financial covenants. Outstanding amounts under the facility bear interest at LIBOR or an alternative base rate plus an applicable margin based on the Company's leverage ratio.

The Company has provided security on the two year facility by way of a charge over the Company's Karowe assets and a guarantee by the Company's subsidiaries, which hold the Karowe assets.

The Bank of Nova Scotia has first ranking security over the Karowe assets.

As at December 31, 2013, the full amount under this facility was available. As a result, the deferred finance charges have been classified under VAT receivables and other.

(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)

## 10. RESTORATION PROVISIONS

The Company's restoration provisions relate to the rehabilitation of its diamond properties. The provisions have been calculated based on total estimated rehabilitation costs and discounted back to their present values. The pre-tax discount rates and inflation rates are adjusted annually and reflect current market assessments. The Company has applied a pre-tax discount rate of 10.8% at December 31, 2013 (10.4% at December 31, 2012) and an inflation rate of 5.8% at December 31, 2013 (6.2% at December 31, 2012) at the Karowe Mine project. The Company has applied a pre-tax discount rate of 9.9% at December 31, 2013 (9.9% at December 31, 2012) and an inflation rate of 6.0% at December 31, 2013 (6.1% at December 31, 2012) at its Mothae Diamond Project. The rehabilitation costs are expected to be incurred in the period of 2022 to 2025. The estimated total liability for reclamation and remediation costs on an undiscounted basis is approximately $15.9 million (December 31, 2012 - $16.9 million).

| | | 2013 | | 2012 |
|---|---|---|---|---|
| **Balance, beginning of year** | $ | 12,242 | $ | 12,486 |
| Revisions to estimated cash flows | | 2,250 | | (1,069) |
| Accretion of liability component of obligation | | 1,628 | | 1,284 |
| Foreign currency translation adjustment | | (1,605) | | (459) |
| **Balance, end of year** | | 14,515 | | 12,242 |
| Less: Current portion | | - | | - |
| Long-term portion of restoration provisions | $ | 14,515 | $ | 12,242 |

## 11. SHARE CAPITAL

The authorized share capital consists of an unlimited number of common shares, with no par value.

(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)

## 12. STOCK OPTIONS

The Company has one rolling stock option plan (the "Plan") approved by the shareholders of the Company on May 13, 2011 which reserves an aggregate of 10% of the issued and outstanding shares of the Company for issuance upon the exercise of options granted. Vesting and terms of the option agreement are at the discretion of the Board of Directors.

Movements in the number of stock options outstanding and their related weighted average exercise prices are as follows:

| | Number of shares issuable pursuant to stock options | Weighted average exercise price per share (CDN$) |
|---|---|---|
| **Balance at December 31, 2011** | **12,031,671** | **$ 0.93** |
| Granted | 150,000 | 1.03 |
| Forfeited | (391,671) | 0.90 |
| Expired | (5,181,300) | 1.13 |
| Exercised | (3,943,700) | 0.70 |
| **Balance at December 31, 2012** | **2,665,000** | **0.88** |
| Granted | 2,775,000 | 0.72 |
| Forfeited | (50,000) | 1.03 |
| Expired | (575,000) | 0.91 |
| Exercised | (606,666) | 0.92 |
| **Balance at December 31, 2013** | **4,208,334** | **$ 0.76** |

The weighted average share price of options exercised during the year was $1.45.

Options to acquire common shares have been granted and are outstanding at December 31, 2013 as follows:

| | Outstanding Options | | | Exercisable Options | | |
|---|---|---|---|---|---|---|
| Range of exercise prices CDN$ | Number of options outstanding | Weighted average remaining contractual life (years) | Weighted average exercise price CDN$ | Number of options exercisable | Weighted average remaining contractual life (years) | Weighted average exercise price CDN$ |
| $0.61 - $0.70 | 2,625,000 | 2.3973 | $ 0.70 | 874,909 | 2.3973 | $ 0.70 |
| $0.71 - $0.80 | 1,033,334 | 0.9068 | 0.80 | 1,033,334 | 0.9068 | 0.80 |
| $0.81 - $0.90 | - | - | - | - | - | - |
| $0.91 - $1.00 | 500,000 | 1.3803 | 0.98 | 366,665 | 1.0526 | 0.98 |
| $1.01 - $1.25 | 50,000 | 1.1452 | 1.13 | 33,333 | 1.1452 | 1.13 |
| | 4,208,334 | 1.8956 | $ 0.76 | 2,308,241 | 1.4984 | $ 0.80 |

(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)

## 12. STOCK OPTIONS (continued)

During the year ended December 31, 2013, an amount of $0.5 million (2012 – $0.3 million) was charged to operations in recognition of stock-based compensation expense, based on the vesting schedule for the options granted.

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with weighted average assumptions and resulting values for grants as follows:

| | 2013 | 2012 |
|---|---|---|
| Assumptions: | | |
| Risk-free interest rate *(%)* | 1.00 | 1.03 |
| Expected life *(years)* | 3.00 | 3.00 |
| Expected volatility *(%)* | 52.85 | 51.23 |
| Expected dividend | Nil | Nil |
| Results: | | |
| Weighted average fair value of options granted *(per option)* | $ 0.25 | $ 0.35 |

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 13. PRINCIPAL SUBSIDIARIES

The Company had the following subsidiaries at December 31, 2013:

| Name | Country of incorporation and place of business | Nature of business | Proportion of shares directly held by the Company (%) | Proportion of shares held by the group (%) | Proportion of shares held by non-controlling interests (%) |
|---|---|---|---|---|---|
| African Diamonds Ltd. | UK | Intermediate holding company | 100 | - | - |
| Lucara Management Services Ltd. | UK | Intermediate services company | 100 | - | - |
| Lucara Diamond Holdings (I) Inc. | Mauritius | Intermediate holding company | 100 | - | - |
| Mothae Diamond Holdings Inc. | Mauritius | Intermediate holding company | - | 100 | - |
| Boteti Diamond Holdings Inc. | Mauritius | Intermediate holding company | - | 100 | - |
| Lucara Diamond South Africa (Pty) Ltd. | South Africa | Intermediate holding company | - | 100 | - |
| Wati Ventures (Pty) Ltd. | Botswana | Intermediate holding company | - | 100 | - |
| Debwat Exploration (Pty) Ltd. | Botswana | Intermediate holding company | - | 100 | - |
| Boteti Mining (Pty) Ltd. | Botswana | Mining of diamonds | - | 100 | - |
| Mothae Diamonds (Pty) Ltd. | Lesotho | Exploration of diamond properties | - | 75 | 25 |

All subsidiary undertakings are included in the consolidation. The proportion of the voting rights in the subsidiary undertakings held directly by the parent company do not differ from the proportion of ordinary shares held.

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 13. PRINCIPAL SUBSIDIARIES (continued)

The total non-controlling interest at December 31, 2013 is $1.5 million (2012 - $1.9 million).

As consideration for acquiring a mining license from the Government of Lesotho (“GOL”), the Company issued the GOL 25% ownership in Mothae Diamonds (Pty) Ltd. (“Mothae Diamonds”). One half of the interest held by the GOL is a free-carried interest and the other 12.5% will ultimately be paid for by the GOL through its share of future dividends paid by Mothae Diamonds, if any.

The GOL’s equity interest must be kept at 25% and cannot be diluted by further equity issuances. As such, the 12.5% free-carried interest portion of the Company’s capital contributions into Mothae Diamonds is accounted for as an equity transaction between shareholders.

Set out below is the summarized financial information for Mothae Diamonds which has non-controlling interests that are material to the Company.

*Summarized balance sheet*

| | | 2013 | | 2012 |
|---|---|---|---|---|
| **CURRENT** | | | | |
| Assets | $ | 890 | $ | 1,247 |
| Liabilities | | (77) | | (360) |
| | | 813 | | 887 |
| **NON-CURRENT** | | | | |
| Assets | | 8,953 | | 11,221 |
| Liabilities | | (608) | | (761) |
| | | 8,345 | | 10,460 |
| **NET ASSETS** | $ | 9,158 | $ | 11,347 |

*Summarized statement of operations*

| | | 2013 | | 2012 |
|---|---|---|---|---|
| Revenue | $ | - | $ | - |
| Depreciation | | - | | (3,262) |
| Loss from continuing operations | | (758) | | (12,911) |
| Loss from discontinued operations | | - | | - |
| Other comprehensive loss | | (2,174) | | (397) |
| **Comprehensive loss** | | (2,932) | | (13,308) |
| Attributable to non-controlling interests | | (367) | | (1,664) |
| Dividends paid to non-controlling interests | | - | | - |

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 13. PRINCIPAL SUBSIDIARIES (continued)

*Summarized statement of cash flows*

| | | 2013 | | 2012 |
|---|---|---|---|---|
| Cash used in operating activities | $ | (538) | $ | (9,746) |
| Cash generated from financing activities | | 742 | | 4,680 |
| Cash generated from (used in) investing activities | | 54 | | (1) |
| Effect of exchange rate on cash | | (46) | | (43) |
| Net increase (decrease) in cash | | 212 | | (5,110) |
| Cash, beginning of year | | 128 | | 5,238 |
| **Cash, end of year** | | 340 | | 128 |

The information above is the amount before inter-company eliminations.

## 14. EXPLORATION EXPENDITURES

| | | 2013 | | 2012 |
|---|---|---|---|---|
| Test mining | $ | - | $ | 7,928 |
| Depreciation | | - | | 3,262 |
| Resource development | | - | | 1,870 |
| Geology | | - | | 652 |
| Office and other | | 849 | | 621 |
| Care and maintenance | | 474 | | - |
| Diamonds recovered | | - | | (1,479) |
| | $ | 1,323 | $ | 12,854 |

## 15. ADMINISTRATION

| | | 2013 | | 2012 |
|---|---|---|---|---|
| Salaries and benefits | $ | 5,275 | $ | 4,651 |
| Professional fees | | 1,490 | | 575 |
| Office and general | | 1,313 | | 1,037 |
| Travel | | 894 | | 741 |
| Stock exchange, transfer agent, shareholder communication | | 775 | | 1,575 |
| Stock based compensation | | 517 | | 286 |
| Management fees | | 489 | | 504 |
| Depreciation | | 423 | | 146 |
| Donations | | 253 | | 19 |
| | $ | 11,429 | $ | 9,534 |

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 16. GAIN ON SALE OF EXPLORATION PROGRAM DIAMONDS

During the year ended December 31, 2013, Mothae Diamonds held a diamond sale and received gross proceeds of $0.9 million. The sale included the rough diamond inventory that was held at December 31, 2012, which was valued using the Company's best estimate of the lower of cost and net realizable value. The Company has recorded a gain on the sale of this inventory in the amount of $0.6 million.

During the year ended December 31, 2012, Mothae Diamonds held one diamond sale and received gross proceeds of $1.5 million. The proceeds on this sale have been netted against exploration expenditures (Note 14).

## 17. INCOME TAXES

Income tax expense differs from the amount that would result from applying the Canadian federal and provincial income tax rates to net income before tax. These differences result from the following items:

| | 2013 | 2012 |
|---|---|---|
| Basic statutory tax rate | 25.75% | 25.00% |
| Net income (loss) before tax | 80,213 | (7,525) |
| Computed income tax expense (recovery) | 20,655 | (1,881) |
| Differences between Canadian and foreign tax rates | (3,962) | (749) |
| Non-deductible expenses and other permanent differences | 1,331 | 71 |
| Change in future tax rates | (376) | 847 |
| Benefits from previously unrecognized tax benefits | (8,458) | - |
| Change in deferred benefits not recognized | 4,461 | 1,104 |
| Exchange rate differences | 1,144 | 655 |
| Other | 196 | (47) |
| | $ 14,991 | $ - |

Income tax expense is derived from income generated at the Company's Karowe Mine. The Company recorded a deferred tax liability during the year, which resulted in a corresponding non-cash future income tax expense of $14.9 million. The deferred tax liability relates to temporary differences between the accounting and tax base of the Company's property, plant and equipment, restoration provisions and non-capital tax loss pools. The Company has applied a significant portion of its non-capital losses in Botswana against taxable income during the year.

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 17. INCOME TAXES (continued)

The movement in deferred tax liabilities during the year, without taking into consideration the offsetting balances within the same tax jurisdiction, is as follows:

| | | 2013 | | 2012 |
|---|---|---|---|---|
| **Balance, beginning of year** | $ | - | $ | - |
| Future income tax expense | | 14,895 | | - |
| Foreign currency translation adjustment | | (637) | | - |
| **Balance, end of year** | $ | 14,258 | $ | - |

| **Deferred income tax assets not recognized** | | 2013 | | 2012 |
|---|---|---|---|---|
| Tax losses | $ | 19,229 | $ | 26,383 |
| Mineral property, plant and equipment | | 58 | | 97 |
| Other deductible temporary differences | | 1,045 | | 601 |
| | $ | 20,332 | $ | 27,081 |

As at December 31, 2013, the Company has non-capital losses for income tax purposes which expire as follows:

| | | 2014 | | 2015 | | 2016 | | Subsequent to 2017 | | No expiry date | | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Canada | $ | 11 | $ | - | $ | - | $ | 49,949 | $ | - | $ | 49,960 |
| United Kingdom | | - | | - | | - | | - | | 5,085 | | 5,085 |
| Botswana | | - | | - | | - | | - | | 30,533 | | 30,533 |
| Lesotho | | - | | - | | - | | - | | 22,245 | | 22,245 |
| | $ | 11 | $ | - | $ | - | $ | 49,949 | $ | 57,863 | $ | 107,823 |

No tax benefit has been recorded for the majority of the Canadian and Lesotho non-capital losses while a tax benefit has been recorded for the Botswana non-capital losses.

(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)

## 18. INCOME PER COMMON SHARE

a) *Basic*

Basic earnings per common share are calculated by dividing the net income attributable to the shareholders of the Company by the weighted average number of common shares outstanding during the year:

| | | 2013 | | 2012 |
|---|---|---|---|---|
| Income (loss) for the year – attributable to Shareholders of the Company | $ | 65,317 | $ | (5,911) |
| Weighted average number of common shares outstanding | | 376,392,625 | | 374,621,554 |
| | $ | 0.17 | $ | (0.02) |

b) *Diluted*

Diluted earnings per share is calculated by adjusting the weighted average number of common shares outstanding to assume conversion of all dilutive potential common shares. For stock options, a calculation is done to determine the number of shares that could have been acquired at fair value (determined as the average market share price of the Company's outstanding shares for the period), based on the exercise prices attached to the stock options. The number of shares calculated above is compared with the number of shares that would have been issued assuming the exercise of stock options.

| | | 2013 | | 2012 |
|---|---|---|---|---|
| Income (loss) for the year – attributable to Shareholders of the Company | $ | 65,317 | $ | (5,911) |
| Weighted average number of common shares outstanding | | 376,392,625 | | 374,621,554 |
| Adjustment for stock options | | 120,365 | | - |
| Weighted average number of common shares for diluted earnings per share | | 376,512,990 | | 374,621,554 |
| | $ | 0.17 | $ | (0.02) |

(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)

## 19. RELATED PARTY TRANSACTIONS

*a) Related party expenses*

The Company incurred the following expenses with Namdo Management Services Limited ("Namdo"), Mile High Holdings Ltd. ("Mile High") and Lundin Foundation ("LF"), companies related by way of directors in common. The Company also incurred professional geological services and laboratory related expenditures from the Mineral Services Group ("MS Group"), a company that is associated with a director of Company. Beginning July 1, 2013, the MS Group is no longer a related party.

| Description of services | Related party | | 2013 | | 2012 |
|---|---|---|---|---|---|
| Management fees | Namdo | $ | 489 | $ | 504 |
| Donations | LF | | 253 | | - |
| Exploration related expenditures | MS Group | | 84 | | 1,916 |
| Aircraft charter | Mile High | | 71 | | 382 |
| | | $ | 897 | $ | 2,802 |

*b) Related party liabilities*

The liabilities of the Company include the following amounts due to related parties:

| | | 2013 | | 2012 |
|---|---|---|---|---|
| Namdo | $ | - | $ | 38 |
| MS Group | | - | | 54 |
| | $ | - | $ | 92 |

*c) Key management compensation*

Key management personnel are those persons having the authority and responsibility for planning, directing and controlling the activities of the Company, directly or indirectly. Key management personnel include the Company's executive officers, vice-presidents and members of its Board of Directors.

The remuneration of key management personnel were as follows:

| | | 2013 | | 2012 |
|---|---|---|---|---|
| Salaries and wages | $ | 2,142 | $ | 1,408 |
| Short term benefits | | 49 | | 112 |
| Stock based compensation | | 402 | | 186 |
| | $ | 2,593 | $ | 1,706 |

(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)

## 20. SEGMENT INFORMATION

The Company's primary business activity is the development and operation of diamond properties in Africa. The Company has three operating segments: Karowe Mine, Mothae Diamond Project and Corporate and other.

**2013**

| | Karowe Mine | Mothae Diamond Project | Corporate and other | Total |
|---|---|---|---|---|
| Revenues | $ 180,507 | $ - | $ - | $ 180,507 |
| Income from mining operations | 103,899 | - | (257) | 103,642 |
| Exploration expenditures | - | (1,323) | - | (1,323) |
| Gain on sale of exploration program diamonds | - | 584 | - | 584 |
| Finance expenses | 96 | (67) | (3,814) | (3,785) |
| Other income (expenses) | (4,836) | 48 | (14,117) | (18,905) |
| Net income before tax for the year | 99,159 | (758) | (18,188) | 80,213 |
| Capital expenditures | (7,822) | - | (43) | (7,865) |
| Total assets | 222,031 | 19,845 | 5,312 | 247,188 |

**2012**

| | Karowe Mine | Mothae Diamond Project | Corporate and other | Total |
|---|---|---|---|---|
| Revenues | $ 41,830 | $ - | $ - | $ 41,830 |
| Income from mining operations | 17,849 | - | (92) | 17,757 |
| Exploration expenditures | - | (12,854) | - | (12,854) |
| Gain on sale of exploration program diamonds | - | - | - | - |
| Finance expenses | 155 | (72) | (3,186) | (3,103) |
| Other income (expenses) | (2,350) | 15 | (6,990) | (9,325) |
| Net loss before tax for the year | 15,654 | (12,911) | (10,268) | (7,525) |
| Capital expenditures | (44,441) | - | - | (44,441) |
| Total assets | 207,037 | 12,468 | 15,846 | 235,351 |

The geographic distribution of non-current assets is as follows:

| | Plant and equipment 2013 | Plant and equipment 2012 | Mineral properties 2013 | Mineral properties 2012 | Other 2013 | Other 2012 |
|---|---|---|---|---|---|---|
| Canada | $ 142 | $ 209 | $ - | $ - | $ - | $ - |
| Lesotho | 486 | 1,369 | 18,408 | 20,865 | 62 | 137 |
| Botswana | 100,258 | 116,817 | 53,653 | 63,780 | - | - |
| | $ 100,886 | $ 118,395 | $ 72,061 | $ 84,645 | $ 62 | $ 137 |

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 21. FINANCIAL INSTRUMENTS

*a) Measurement categories and fair values*

As explained in Note 3, financial assets and liabilities have been classified into categories that determine their basis of measurement and, for items measured at fair value, whether changes in fair value are recognized in the consolidated statements of operations or consolidated statements of comprehensive loss. Those categories are: fair value through profit or loss; loans and receivables; available for sale assets; and, for liabilities, amortized cost.

The fair value of the Company's available for sale financial instruments is derived from quoted prices in active markets for identical assets. The fair value of the Company's long-term debt approximates their carrying amounts due to the fact that there have been no significant changes in the Company's own credit risk. The fair value of all other financial instruments of the Company approximates their carrying values because of the demand nature or short-term maturity of these instruments.

The Company's financial assets and liabilities are categorized as follows:

| | December 31, 2013 | December 31, 2012 |
|---|---|---|
| **ASSETS** | | |
| Loans and receivables | | |
| Cash | $ 49,364 | $ 13,261 |
| Trade receivables | - | 1,503 |
| Other receivables | 233 | 248 |
| | $ 49,597 | $ 15,012 |
| Available for sale | | |
| Investments | 90 | 86 |
| | $ 90 | $ 86 |
| **LIABILITIES** | | |
| Amortized cost | | |
| Trade payables | $ 9,169 | $ 7,429 |
| Accrued liabilities | 6,322 | 7,266 |
| | 15,491 | 14,695 |
| Long-term debt | - | 50,954 |
| | $ 15,468 | $ 65,649 |

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 21. FINANCIAL INSTRUMENTS (continued)

*b) Fair value hierarchy*

The following table classifies financial assets and liabilities that are recognized on the balance sheet at fair value in a hierarchy that is based on significance of the inputs used in making the measurements. The levels in the hierarchy are:

Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities
Level 2 - Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices)
Level 3 - Inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs).

| | December 31, 2013 | December 31, 2012 |
|---|---|---|
| Level 1 | | |
| Investments | $ 90 | $ 86 |
| Level 2 and Level 3 – N/A | | |

*c) Financial risk management*

The Company's financial instruments are exposed to certain financial risks, including commodity price, currency, credit, liquidity and price risks.

*Commodity price risk*

The Company is subject to commodity price risk. Diamonds are not a homogenous product and the price of rough diamonds is not monitored on a public index system. The fluctuation of prices is related to certain features of diamonds such as quality and size. Diamond prices are marketed in U.S. dollars and long term U.S. dollar per carat prices are based on external market consensus forecasts. The Company does not have any financial instruments that may fluctuate as a result of commodity price movements.

*Currency risk*

The Company is exposed to the financial risk related to fluctuating foreign exchange rates. All sales revenues are denominated in U.S. dollars, while directly related costs are denominated in Botswana Pula. At December 31, 2013, the Company is exposed to currency risk relating to U.S. dollar cash held within the Company's Botswana entity. Based on this exposure, a 10% change in the Botswana Pula/U.S. dollar exchange rate would give rise to an increase/decrease of approximately $3.6 million in net income for the year.

**(All amounts expressed in thousands of U.S. Dollars, unless otherwise indicated.)**

## 21. FINANCIAL INSTRUMENTS (continued)

*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 majority of the Company's cash is held through a large Canadian financial institution with a high investment grade rating. Considering the nature of the Company's ultimate customers and the relevant terms and conditions entered into with such customers, the Company believes that credit risk is limited as customers pay on receipt of goods.

The carrying amount of financial assets recorded in the financial statements, net of any allowance for losses, represents the Company's maximum exposure to credit risk.

*Liquidity risk*

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. Cash flow forecasting is performed in the operating entities of the Company and aggregated in head office which monitors rolling forecasts of the Company's liquidity requirements to ensure it has sufficient cash to meet operational needs at all times. Such forecasting takes into consideration the Company's debt financing plans.

The Company's estimated minimum contractual undiscounted cash flow requirements for financial liabilities were:

| **December 31, 2013** | **Less than 3 months** | **3 months to 1 year** | **2-5 years** | **Over 5 years** |
|---|---|---|---|---|
| Trade payables and accrued liabilities | $ 15,491 | $ - | $ - | $ - |
| Long-term debt | - | - | - | - |

| **December 31, 2012** | **Less than 3 months** | **3 months to 1 year** | **2-5 years** | **Over 5 years** |
|---|---|---|---|---|
| Trade payables and accrued liabilities | $ 14,695 | $ - | $ - | $ - |
| Long-term debt | - | 33,333 | 21,167 | - |

*Interest rate risk*

The Company's exposure to interest rate risk results from the effects that changes in interest rates may have on the reported value of cash. There is minimal risk that the Company would recognize any loss as a result of a decrease in the fair value of any short-term investments included in cash due to their short-term nature. Based on the balance of cash at December 31, 2013, and assuming that all other variables remain constant, a 0.25% change in the U.S. prime rate would result in an increase/decrease of $0.1 million in the interest accrued by the Company per annum.

## 21. FINANCIAL INSTRUMENTS (continued)

*Equity market risk*

The Company is exposed to equity price risk arising from its marketable securities, which are classified as available-for-sale.

## 22. CAPITAL MANAGEMENT

The Company's objectives when managing capital are to safeguard the Company's ability to continue as a going concern in order to pursue the development of its mineral properties and to maintain a flexible capital structure which optimizes costs of capital at an acceptable risk.

In the management of capital, the Company considers items included in equity attributable to shareholders to be capital.

The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the Company's assets. In order to maintain or adjust the capital structure, the Company may attempt to issue new shares or debt instruments, acquire or dispose of assets, or to bring in joint venture partners.

In order to facilitate the management of its capital requirements, the Company prepares annual expenditures budgets that are updated as necessary depending on various factors, including successful capital deployment and general industry conditions. The annual and updated budgets are approved by the Board of Directors.

## 23. COMMITMENTS

In conjunction with the building and commissioning of a plant upgrade at the Karowe Mine, the Company has committed to approximately $1.2 million in capital expenditures.

## 24. SUBSEQUENT EVENTS

*(a) Sale of Mothae plant*

In December 2013, the Company signed a memorandum of understanding ("MOU") with Paragon Diamonds Ltd. ("Paragon") for the sale of certain kimberlite processing plant and diamond recovery assets. Under the terms of the MOU, the Company will receive consideration of:

- $0.1 million cash and 4,434,589 common shares of Paragon on signing of the asset purchase agreement
- $0.2 million cash and 5,543,236 common shares of Paragon on commencement of relocation of the assets from the Mothae site. The number of common shares will be adjusted should an equity raise be completed by Paragon at a price less than £0.04.

The signing of the asset purchase agreement is anticipated by the end of February 2014.

As part of the MOU, the Company received a non-refundable deposit of US$50,000 from Paragon in December 2013.

*(b) Litigation*

Upon completion of the African Diamonds plc ("AFD") Arrangement Agreement which resulted in the Company holding an undivided 100% ownership interest in the Karowe Mine, the Company retained certain liabilities related to legal proceedings initiated by two former directors of AFD against AFD alleging entitlement to a 3% NSR on production from the Karowe Mine. The claim was heard in the Botswana High Court in early June 2011. The High Court delivered its ruling in August 2011 dismissing the claims against AFD, with costs awarded against the plaintiffs.

In September 2011, the Company was notified that the plaintiffs, in the legal proceedings initiated against AFD, had filed an appeal of the decision of the High Court of Botswana dismissing the plaintiff's claims with costs awarded in favor of AFD. The appeal was heard in the Appeal Court of Botswana in January 2014 and judgment was handed down in February 2014.

The Court of Appeals, the highest court in Botswana upheld the previous ruling by the Botswana High Court, dismissing the claim against African Diamonds, with costs awarded against the plaintiffs. The decision is final and there is no further recourse against African Diamonds.

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